

U.S. Congress, Senate. →

INVESTIGATION OF THE FINANCIAL
CONDITION OF THE UNITED STATES

COMMENTS OF ECONOMISTS, PROFESSORS,
AND OTHERS IN RESPONSE TO
THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

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SECOND SESSION

CHAPTER 5



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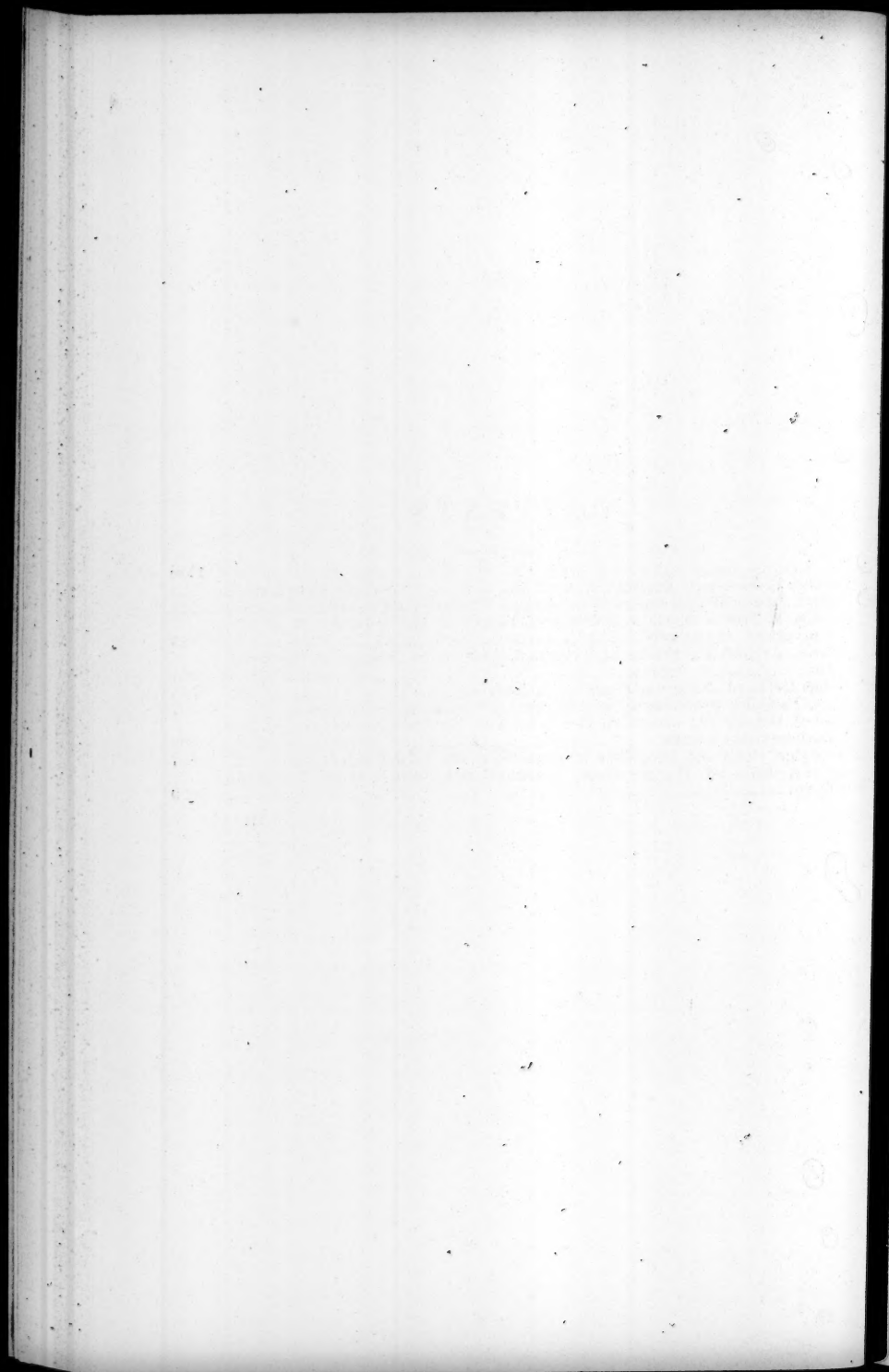
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INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

THE AMERICAN BANKERS ASSOCIATION,
DEPARTMENT OF MONETARY POLICY,
New York, N. Y., April 30, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: You will find enclosed my answer to the questionnaire enclosed with your letter of February 17. I hope it will be helpful. Let me express my appreciation for the opportunity of participating in this questionnaire and especially for your courtesy in granting me an extension of time to finish my answer. It so happened that my agenda was unusually full over the past 2 months and it would have been impossible for me to finish my reply by April 1.

Would you be good enough to let me know whether or not your committee plans to print my reply, and if so, what the publication date will be?

Sincerely yours,

E. SHERMAN ADAMS.

Enclosure.

HOW CAN WE ACHIEVE ENDURING PROSPERITY?

Answer of Dr. E. Sherman Adams, Deputy Manager, American Bankers Association, to the Senate Finance Committee's questionnaire of February 17, 1958

(These comments reflect the personal opinions of the author and should not be regarded as representing the official views of the American Bankers Association.)

There is broad agreement that our major economic goal is to achieve enduring prosperity. This clearly implies the maintenance of high levels of production and employment and a reasonably stable price level. It also implies a satisfactory rate of economic growth.

These elements of economic stability are not in conflict but are inseparably interdependent. No one of them can be achieved on a sustainable basis without the other two.

Conflict would exist if we were to push any one of these objectives to an extreme instead of aiming at good overall performance. If we were to strive for maximum growth at all times, our economy would be dangerously unstable. If we were to try to maintain maximum employment at all times, we would have inflation. Even the pursuit of maximum price stability might at times interfere with satisfactory

growth, employment, and production. Our aim, therefore, should be a balanced mix of these ingredients of enduring prosperity.

NOT 1 PROBLEM, BUT 2

Most of us have long been accustomed to thinking of the problem of economic instability as consisting of the problem of the business cycle, the problem of mitigating booms and recessions. But today something new has been added. Indeed, economic instability now consists not of 1 problem, but 2. In addition to the age-old problem of the business cycle, we are now confronted with a new problem: That of preventing a continuing depreciation of the dollar over the years, popularly known as creeping inflation.

This new problem has emerged because of the inflationary biases that have developed in our economy over the past several decades. These biases constitute a new and serious problem not only because they push up prices during good times but more especially because they prevent prices from ever readjusting downward. In short, price increases have tended to become irreversible.

This has never been the case before in the United States. We have had periods of price inflation, to be sure, but they were invariably followed by periods of deflation. Throughout our history, major wars always caused inflation but prices always subsequently returned to approximately prewar levels until World War II. The inflation of World War II has become permanently imbedded in our economy.

And so has the inflation of the Korean war, and, for that matter, most of the price inflation of 1954-57. In fact, even during the recession year of 1958, we are witnessing a further rise in the most important price in our economy, the price of labor.

These inflationary biases have actually been at work in our economy for several decades but until recent years their effects were somewhat obscured, first by the wartime inflation and then by the unusual character of the postwar period. They became somewhat more apparent during the Korean war period but it has only been over the past 4 years that they have emerged clearly to the general view.

The pattern of the past 4 years has been, in brief: A period of boom aggravated by inflation, then a recession aggravated by high prices, and for the period as a whole, further erosion in the purchasing power of the dollar. The problem of economic stability for the future may be essentially that of preventing a repetition of this pattern—or of preventing it from becoming worse, if the people should lose confidence in the long-run integrity of the dollar.

The new resistance of our economy to price declines has its bright side, of course. Our past periods of price deflation have often been extremely painful and it is certainly reassuring to know that we will in all probability not experience such severe deflations in the future. But this is no reason to minimize the dangers of inflation that loom ahead.

The emergence of this long-run inflationary threat has fundamentally changed the whole problem of maintaining economic stability. We should try to come to grips with the fundamental elements of this new problem and to think through its important implications for public policy. We should no longer think in terms of anticyclical

policy alone; we should think in terms of anticyclical plus anti-inflation policy.

IMPLICATIONS FOR PUBLIC POLICY

Let us consider some of the implications of this problem for public policy.

During a period of business expansion, prices normally tend to rise. However, if public policymakers are aware that price increases may never be reversed, they will naturally feel that it is highly important to try to combat rising prices. The net result is likely to be that some inflation will occur anyway but that economic growth will be either retarded or interrupted by a recession.

Similarly, when a recession starts, there will be a strong reluctance to adopt corrective measures promptly for fear of starting the inflationary spiral again. The existence of the inflationary biases in our economy give real justification to this reluctance. The net result, however, is likely to be that inflation will be merely retarded temporarily and that recovery will be delayed.

There is urgent need, therefore, to do what we can to correct or offset these inflationary biases in our economy—in addition to improving our techniques for combating the business cycle itself. We have already made great progress with respect to this latter problem, but very little with respect to the former.

Before suggesting what might be done, however, let us examine the nature of these two distinct, though related, problems: creeping inflation and the business cycle.

OUR INFLATIONARY BIASES

There is obviously ample room for debate as to whether our economy really does have serious inflationary biases, and if so, what should be done about them. Rather than attempting anything like a comprehensive treatment of these questions, I should like here simply to single out four major aspects of this subject that deserve particular attention: (1) industrial wage and price policies, (2) Federal fiscal policies, (3) interest rates, and (4) the Employment Act of 1946.

(1) Let us look first at the delicate and crucial area of industrial wage and price policies. I use this inclusive phrase because although some people are willing to talk about inflationary wage increases and others to talk about inflationary pricing policies of business, I fear we will continue to make little progress with this basic problem until we recognize that these things are inextricably interrelated. Interacting together, they have produced the ominous wage-price spiral.

The basic facts of this situation are too well known to require elaboration here. When wages, including fringe benefits, rise more rapidly than productivity, the result is bound to be higher prices. And when business concerns follow pricing policies designed to pass along to the public most or all of their added labor costs (and sometimes more), then the result is a formidable wage-price spiral. And that, as is well known but not always acknowledged, is just what has been happening in this country in recent years. Indeed, this process has become such a national habit that it has aptly been referred to as institutionalized inflation.

Your questionnaire contains only one reference to this basic problem; namely, the question regarding the effects of escalator clauses in wage contracts. It goes without saying that escalator clauses tend to be inflationary—practically by definition. On the other hand, the elimination of such clauses would not by any means solve the wage-price spiral.

It has been suggested that one approach to this problem should be to try to speed up the improvement in industrial productivity. There are opportunities for doing this, of course. Featherbedding has become so imbedded in the railroad industry that we seldom even bother to mention it any more. Another prize example, as everyone knows, is the residential construction industry. Certainly these obvious opportunities for improving productivity should not be ignored but, looking at the matter realistically, progress in these areas will not solve the wage-price spiral either.

Since this is not my field of competence, I shall refrain from trying to prescribe what should be done. Certainly we should be hesitant to infringe the freedoms either of business management or of organized labor. On the other hand, when the combined actions of these two groups seriously threaten the stability of the American economy at this critical juncture of history, then they pose a problem that we cannot afford to ignore. Mere exhortation and appeals for statesmanship are not likely to have much lasting effect. There is clearly need for carefully thought-out modifications in the rules under which this game is played.

OUR INFLATIONARY BUDGET

(2) Another major source of inflationary bias in our modern economy is the fiscal policies of the Federal Government.

One serious defect is our working philosophy with respect to the Federal budget. Years ago, the goal of balancing the budget during good times was adequate. But this is not an adequate goal today because of the enormously increased magnitude of the budget. At present levels, a balanced Federal budget is inflationary. Yet, although this is true—for a number of reasons, most of which are quite familiar—most people are content merely to balance the budget, or have it show a nominal surplus, even at the height of an inflationary boom.

With a budget the size of ours, sound fiscal policy calls for a combination of tax and expenditure policies that will produce substantial budgetary surpluses for debt reduction during periods of active business. This will take a lot of educating, of course, and, also, political courage, but the sooner we recognize the need the better.

Another inflationary aspect of the Federal budget is the existing system of high price supports for farm products. This, too, of course, is another complicated problem, but it is at least clear that we should work toward a lower, less inflationary level of farm support prices.

THE CHEAP-MONEY FALLACY

(3) Another inflationary factor I would like to mention is the widespread bias in favor of low interest rates. This is a very difficult thing to measure, and, since I am a monetary economist who has been connected with the banking business for a good many years, perhaps I

am inclined to exaggerate its importance. Nevertheless, this is certainly not a matter to be lightly dismissed by anyone who is seriously interested in preventing inflation.

The main points here are quite simple, though they are not generally appreciated. Many people, including some in public office, seem to think that the one price that should be held down at all times is the price of borrowing money. This may have highly inflationary consequences. For one thing, monetary policy cannot combat inflation effectively without restricting the supply of credit, and this cannot be done unless interest rates are permitted to rise. Also, over a period of years, if interest rates are kept at artificially low levels, this is bound to aggravate the inflationary imbalance between the supply of savings and the demands for loanable funds.

This could become increasingly serious over the years ahead if inflationary tendencies are not kept in check. At some point, rising prices can discourage people from saving money, especially if the reward for saving is low. This danger may seem remote today, but it is not something to be pooh-poohed. If such a psychology ever should develop among the people of this country, we would be in serious trouble.

For these reasons, I believe that the existing bias in favor of low interest rates is a threat to economic stability. Those in public life who make a fetish of low interest rates at all times are doing great disservice to the American people.

(4) Finally, there is the inflationary bias contained in the statement of economic objectives in the Employment Act of 1946. This could be easily corrected by an amendment making it clear that one of the primary objectives of public economic policy in the United States is to avoid inflation. I believe that such an amendment might have a salutary effect over the years.

THE PROBLEM OF THE BUSINESS CYCLE

In addition to these inflationary biases, we have the venerable problem of the business cycle.

There is, of course, a vast literature about the business cycle, and there would be little point in trying to summarize it here. There are two points, however, that may be worth emphasizing.

First, despite the progress that has been made, there is still a great deal that we do not know about the business cycle and how to deal with it. There is need for encouraging and stepping up the research that is being done in this area. It is almost unbelievable to contrast the vast scale of our research in the physical sciences and in industry—and the pride we take in such research—with the appalling paucity of research being done on this vital problem of economic instability. Perhaps this is something for your committee to ponder.

Second, although there is much we do not know about the business cycle, there is one basic fact we do know; namely, that we cannot achieve economic stability unless we curb inflationary booms. Yes; this sounds simple enough, but, unfortunately, it is all too often ignored—and that applies, of course, to public as well as private policymakers.

You ask the chief causes of the current recession. In oversimplified terms, this recession is primarily an inevitable reaction from the infla-

tionary boom that preceded it. In turn, the factors responsible for the boom were the usual cyclical factors that you will find enumerated in any economics textbook, aggravated by the inflationary biases already discussed, and, also, aggravated by certain governmental policies, chiefly:

(1) Excessive stimulation of residential construction. This caused an enormous inflation in construction costs, and this, in turn, aggravated inflation in other segments of the economy. It also contributed to the speedup of industrial construction that featured the 1956-57 boom. Now that we really need an expansion of residential construction, many markets have been saturated and much of our ammunition has been used up. Public policy with respect to housing has had a destabilizing effect on our economy, whereas, if wisely conceived, it could have an important stabilizing influence over the course of the business cycle.

(2) Unwise Government spending. The annual "pork barrel" bill, for example. To say the least, Congress did not do an outstanding job of curbing unnecessary or postponable Government expenditures.

The basic need, clearly, is for more widespread understanding of the importance of restraint during the expansionary phase of the business cycle—both on the part of the Congress, and also, of course, on the part of the public generally.

THE ROLE OF CREDIT CONTROL

There is widespread agreement that financial measures—monetary and credit policies, debt management, and fiscal policies—can make an important contribution to economic stability. This view seems to be reflected in your questionnaire, and it is one with which I am in general accord, though with one reservation; namely, that as a practical matter, I doubt whether Federal debt management can ever operate as an important anticyclical technique.

Let us first consider the role of credit regulation—what its record has been in recent years and what can be expected from it in the future.

Prior to the Federal Reserve-Treasury "accord" of 1951, monetary policy in its traditional role of an economic stabilizer was, of course, practically inoperative. Since then, Federal Reserve policy has become a highly flexible and useful weapon for helping to mitigate the swings of the business cycle.

In general, the monetary authorities have exhibited great skill and courage in administering monetary policy. There have been some errors of judgment from time to time, naturally. That is to be expected. On the whole, however, allowing for the difficulties inherent in this task, the record has been excellent. It seems clear that, on balance, monetary policy has made a useful contribution to the stability of the economy over this period.

On the other hand, experience since 1951 has also demonstrated afresh the important limitations as to what the Federal Reserve can be expected to accomplish with its existing powers—which consist chiefly of its ability to regulate the availability of bank reserves. For one thing, the policies of nonbank lenders and investors have not always responded promptly to Federal Reserve policy—a case in point being the progressive liberalizing of installment credit during

1955. Also, even bank lending policies may not have been as responsive to monetary policy as is generally supposed.

This, naturally, raises the question as to whether additional controls over private credit may be needed to supplement the Federal Reserve's existing powers. Various suggestions have, of course, been made along these lines, and some of them may deserve consideration. In general, we should avoid new controls unless they promise to have important stabilizing results. It would certainly be foolish to put credit in a straitjacket of excessive regulation and to leave undone other things that need urgently to be done. On the other hand, if careful study indicates that additional credit controls are really needed, then we should adopt them.

The most obvious weakness in the credit picture is the fact that governmental credit agencies have at times pursued policies in direct conflict with national monetary policy. A few years ago, for example, when the Federal Reserve was tightening bank credit to curb inflation, the Federal Government, through Fannie May, was simultaneously pumping new funds into the mortgage market. At the same time, the Federal home loan banks greatly increased their advances to Federal savings and loan associations. Numerous examples could be cited.

Plainly there is need for better coordination of the policies of Government credit agencies with Federal Reserve policy—not vice versa. This is obviously a complicated problem that cannot be cured simply by passing a law. Nevertheless, it might do some good if the Congress were to enact a law making it clear that it is a primary responsibility of every Government agency empowered to grant or guarantee credit, to see to it that its credit policies are at all times consistent with Federal Reserve policy.

Before leaving this subject of credit regulation, two additional points deserve emphasis:

(1) It should be clear that economic stability cannot be achieved by credit controls alone. They can make an important contribution but we should not expect them somehow to offset the unstabilizing effects of unwise policies in other areas. Indeed, it would be highly dangerous to rely too heavily on what can be accomplished by monetary policy.

(2) If monetary management is to be permitted to make its full potential contribution to economic stability, then it must have widespread understanding and support—or at least toleration. This imposes on all of us, especially on men holding public office, an obligation to refrain from irresponsible criticism of the Federal Reserve authorities and of their policies. There has been an ominous tendency in some quarters in recent years to attack credit restraint in a highly irresponsible manner. If continued, this could eventually have serious consequences for the stability of our economy.

THE ROLE OF FISCAL POLICIES

So much has been said and written about the anticyclical use of Federal fiscal policies that I shall confine my comments to a few specific points:

(1) It seems clear that fiscal policies could be used much more effectively in combating economic instability than they have been in the past. It should be possible to achieve a better scheduling of Federal public works and especially to cut down on postponable expenditures during periods of active business.

(2) There is need for establishing a tradition of greater responsibility with respect to tax policy. This would make it possible to use tax policy more effectively as an anticyclical weapon. Many who oppose cutting taxes at the present time to combat the recession are opposed because they fear that the tax cut might not be sensible in form and that it might not prove to be temporary. We should try to work toward a rational policy of raising tax rates during booms and lowering them during recessions.

(3) There is clearly a need for better budgetary procedures within the Congress. Some progress has been made in this direction but tax and appropriation bills are still enacted without adequate consideration of their relationship to the overall budget situation. Another item here is the matter of the item veto—one item that could be enacted without the loss of a single vote.

(4) It may well be that our tax system needs to be thoroughly reformed. Indeed, a case could probably be made that our present tax system tends to be inflationary. In any event, given the inflationary bias our economy does have, it certainly does not make sense to have a tax system that penalizes saving and encourages borrowing. If it must lean in one direction or the other, it should be the opposite direction.

FINANCIAL MEASURES WILL NOT SUFFICE

Even if we strengthen our credit and fiscal policies, these will not suffice to achieve economic stability. Notably, whether we like it or not, there remains the wage-price spiral. Financial measures may temper this spiral, slow it down at times, but they cannot, as a practical matter, keep it under control. Wage negotiations reset the valves that control a substantial part of the money flow through our economy. When these valves are opened too rapidly, their effects cannot be offset by tightening the financial valves without causing a business recession and unemployment.

As previously suggested, this problem of the wage-price spiral is one that must be dealt with directly. Until we face up to this problem, our economy will continue to be threatened with chronic instability.

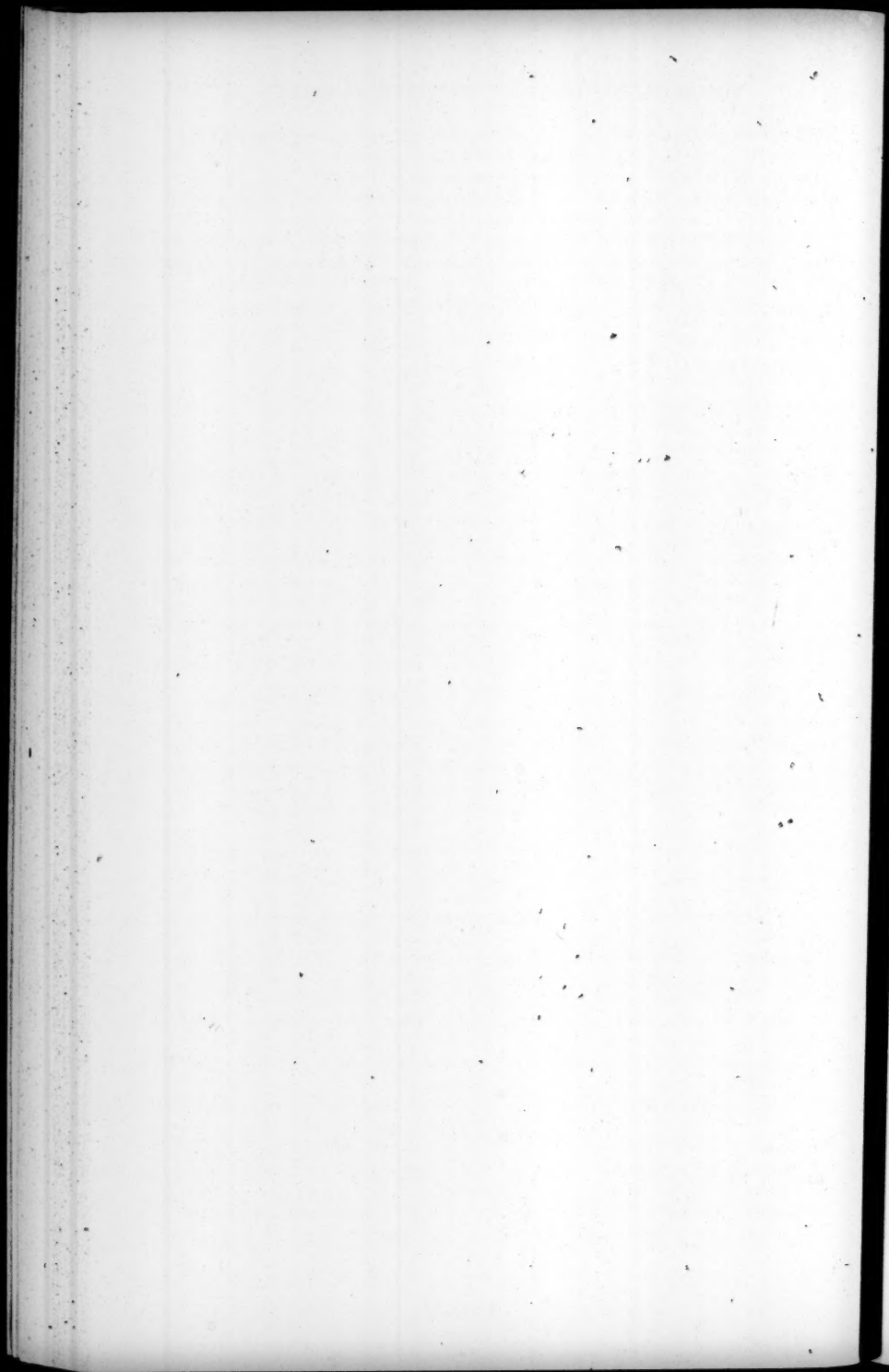
In addition, and in conclusion, there is one more matter to which I should like to invite your attention: namely, the matter of organization for policymaking within the Federal Government. Here we are today confronted with a problem of crucial importance: the problem of maintaining a stable economy in a world where the very survival of civilization will in all probability depend upon our success. The question I raise is whether we are adequately organized to deal with this complex and momentous problem.

To be sure, the Federal Reserve System has a fine staff, and we now have a Council of Economic Advisers, also equipped with an excellent staff. In addition, various individuals are invited from time to time to present their views to quite a variety of congressional committees, and some of these committees in turn have good staffs of their own.

And, of course, there are other agencies and groups that participate in the formulation of public economic policies.

But do all of these groups and procedures add up to the most effective organization that we can possibly put together for dealing with the vital problems with which we are confronted? You are obviously in a much better position to answer this question than I am. From this distance, however, it would seem to me that this may be a question to which Congress should perhaps devote careful consideration.

APRIL 30, 1958.



COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK,
DEPARTMENT OF ECONOMICS,
New York, N. Y., April 12, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Under separate cover, I am today mailing to you the statement I have prepared in answer to your letter and questionnaire of February 17. I must again apologize for the fact that unexpected pressures of university work and typing delays have prevented me from getting the statement into your hands by April 1, the date you had suggested.

I found it most effective to group the questions you had posed into three main sections, dealing with the causes of the post-1946 inflation; the causes and cure of the present business recession; and longer run economic goals. For your possible convenience, the central argument of these sections is presented in a two-page summary at the beginning of the statement.

It was a great pleasure to prepare this document for your committee. Although it comes a little late, I hope it may still be of service to your committee in their crucially important deliberations.

Sincerely yours,

JAMES W. ANGELL,
Professor of Economics.

THE FINANCIAL CONDITION OF THE UNITED STATES: THE POST-1946 INFLATION, THE CAUSES AND CURE OF THE PRESENT RECESSION, AND LONGER RUN GOALS

Reply to a Questionnaire From the Committee on Finance, the United States Senate by James W. Angell, Professor of Economics, Columbia University, April 8, 1958.

SUMMARY

1. Inflation and deflation are defined here in terms of the movements of the prices of mass-consumption goods.

2. The chief cause of the inflation after 1946 was the excessive expansion of aggregate monetary demand. This expansion was due to a number of factors, chiefly the postwar readjustment in this country and postwar reconstruction needs abroad, the cold war, the policies of the Treasury and the Federal Reserve, the policies of Congress and the Executive with respect to taxation and nondefense spending, and State and local government spending. Greater restraint by Congress with respect to nondefense spending, more powerful tax measures and greater monetary restraint would, in combination, have prevented any substantial inflation.

3. The present recession is in part a reaction from an overexpansion of the current output of finished products, and "inventory recession"; but is in part a reaction from the overexpansion in the last 2 or 3 years of plant and equipment. This last is what makes it so ominous, because an overexpansion of capacity may take years to work off. The situation is rapidly becoming critical, and is beginning to look like 1929-32, not 1953-54. It is critically important to our vital national interests to stop the recession and start a recovery at the earliest possible moment, not only because of the suffering which a serious depression would impose on our own people, but also because of the severe damage it would do to the economies of our now-friendly trading partners abroad, and thus to our international political position. It could easily lose us the cold war. Because time is required for countermeasures to take hold, a number of steps should be begun at once: first, personal and corporate income tax cuts, and possibly excise tax cuts; second, a much greater easing of monetary policy; and third, increased government expenditures, especially on unemployment benefits, foreign aid, and assistance to State and local government construction projects. No one of these three types of measures will alone do the job, but the psychological impact and the direct effects of the combination of the three will. The greater the initial effort the sooner will recovery start, and, therefore, the shorter will be the period for which the measures must be continued. They will also be correspondingly less expensive. The postrecovery inflationary danger can be entirely avoided if Congress and the Federal Reserve later enforce sufficiently strong restraints, in the form of increased tax rates, reduced government spending, and tight monetary policy.

4. The major long-run economic goals should be full employment, price stability, and the maintenance of economic freedom. To achieve them, price stability should be made an explicit objective of monetary policy by amendments to the Employment Act and the Federal Reserve Act; the Federal Reserve Act should be amended in several ways, and a National Economic Commission should be established to coordinate, in the light of the goals just described, the operations of all the governmental and quasi-governmental agencies that have financial or fiscal powers. The ultimate and only key to the real achievement of these goals, however, is necessarily the will and self-discipline of the Congress and the President.

INTRODUCTION

The letter addressed to me by Senator Byrd on February 17, 1958, included a list of 17 suggested questions. For brevity and clarity, I shall combine most of them into four main groups, which I propose to take up in the following order:

- I. The definition of inflation and deflation.
- II. The causes of the United States inflation since 1946.
- III. The causes and cure of the present recession.
- IV. Longer run economic goals and means to achieve them.

A fifth group of questions, concerning technical aspects of our monetary and fiscal system, is best handled for the present purposes in connection with the discussion of the other groups.

I shall not undertake any detailed statistical analyses. Such analyses have been made many times, and at best tell us where we have been in the past. As I understand it, the chief interest and concern of the committee is rather with where we are now and where we are going.

I. THE DEFINITION OF INFLATION AND DEFLATION

So many definitions of inflation and deflation have been used in the past, for so many different purposes, that no one definition can be regarded as necessarily "right." The terms have commonly been used to describe the movements of one or more groups of prices that are thought to be especially significant. They have also been used, however, to describe the effects and sometimes even the supposed causes of such movements. Moreover, absolute and continued fixity of prices is presumably impossible in a competitive individualistic society. Therefore, any definition must include some statement about how great or how rapid a price change can be, before it is described as constituting inflation or deflation. All of these matters involve questions of judgment and preference, on which equally competent students may disagree.

Without further discussion, I shall define inflation and deflation in terms of the movements of the prices of those kinds of goods and services which are typically bought in some volume for their own consumption by the great majority of the individuals and households in the country. This means, in effect, bought by the lower and middle income groups. Hamburgers and overcoats are in; diamonds and caviar should not be. As to the permissible degree of fluctuation, before inflation or deflation can be said to exist, I do not know what the "right" maximum range is, but I suggest that it be set at not more than 3 or 4 percent above and below the figure for some selected base year or base period. Finally, since products and tastes change with time, I suggest that the base period should never be more than perhaps 10 years in the past.

To summarize, I shall define inflation as existing whenever an appropriately constructed index of consumer prices rises more than 3 or 4 percent above an appropriately chosen base figure, which relates to a period not more than about 10 years in the past.¹ And so conversely for deflation.

II. THE CAUSES OF THE UNITED STATES INFLATION SINCE 1946

The fact that the United States has suffered from a serious inflation since 1946 is beyond dispute, no matter what measurements are used. From the end of the Second World War in 1945 to March 1958, consumer prices (Bureau of Labor Statistics) rose about 60 percent, wholesale prices 73 percent. From the 1946 low to the 1957 peak the money value of our gross national product—our total output—rose some 50 percent more than the estimated physical quantity of the output itself, which implies an average price rise for the aggregate of all goods and services of about 50 percent. Whatever figure we take, the fact that there has been a very substantial and injurious inflation in

¹ The statistical problems involved in constructing an appropriate price index are substantial, but will not be explored here.

the last 12 years is incontestable. It is worth emphasizing, however, that the inflation did not proceed at an even pace. Half of it took place in the 3 years immediately after the end of the war. Thereafter, price leveled off until the Korean War, which forced them up by another 13 percent of the 1949 figure. Then they again leveled off until early 1956, when a new "creeping" inflation began which is still continuing, despite the current recession.

The damage which an inflation of this size does is familiar to everyone. It eats away the real value of all incomes and all wealth that are fixed in dollar terms, notably bonds, mortgages, saving accounts, annuities and life-insurance policies. Since 1946 these have lost a third of their value, and since 1938 a half. This process of gradual invisible confiscation is not so serious for the well-to-do, who usually have sufficient knowledge and opportunities to protect themselves if they wish, but for the lower income groups it can be catastrophic. It constitutes an unplanned but powerful change in the distribution of wealth and income, in favor of equity holders and debtors. There is no general reason to think that this redistribution is socially desirable, nor to think—as some allege—that without slow but fairly continuous inflation the growth of real output would be seriously hampered.

The causes of the inflation since 1946 have been numerous, interconnected, and hotly debated, both among political leaders and among professional economists. There has been a great temptation to single out some one "cause," in order to attach the blame for inflation to a particular group, policy, or political party. My purpose here, however, is not primarily to try to fix responsibility, but rather to examine the past in the hope that it will suggest how to set up better arrangements in the future.

It seems quite clear that three principal sets of factors either directly caused or at least powerfully contributed to the size and duration of the generally inflationary movement since 1946. They are: (1) the great increase in aggregate monetary demand—in the total volume of actual dollar spending on goods and services by individuals, business firms, and governments; (2) the downward inflexibility of many classes of money costs and money prices; and (3) the considerable number of so-called cost-push forces, which have tended to raise current monetary costs at each point in time relative to current product prices, and have thus encouraged or even compelled business firms to raise these prices further. It is worthwhile to look at the more important of these factors, not in the expectation of discovering some new and unheralded cause—on the contrary, they are all long familiar—but because I think significant conclusions about future policy will at once be forced to the front.

1. Increased aggregate monetary demand

The fact that aggregate monetary demand increased enormously after the end of the Second World War is self-evident. From the end of 1945 to the end of 1957 this aggregate demand, as measured by the number of dollars' worth of gross national product which was bought, more than doubled. In itself, this was fine. But over half of the rise was due to the successive increases in prices; less than half was due to increases in actual physical output itself. Why did money demand run so far ahead of physical output? A series of factors

were responsible, some operating only at certain times but others throughout the post-war period. The chief ones were these:

(a) *The financing methods and controls of the Second World War.*—The severe wartime restraints on consumer spending (chiefly rationing, price controls and savings bond campaigns) created an enormous backlog of potential demand, while the fact that more than half of the cost of the war was financed by floating salable or redeemable bonds meant that when the war was over and the controls were abruptly removed, ample spending power would be available. Much of the price rise to 1948 was for all practical purposes inevitable, given that the wartime controls were removed suddenly rather than gradually.

(b) *The enormous foreign and especially European need for imports of goods for relief, rehabilitation and reconstruction after the war*—imports which could come in the main only from the United States.

(c) *Treasury interest-rate policy to 1951*, with the reluctant acquiescence and support of the Federal Reserve. The result was, of course, that the interest rates on all Federal securities, and also in the short-term money markets at large, were kept low (even long-term taxable governments never rose above $2\frac{1}{2}$ percent); the commercial banks and the general public remained very liquid, and the door was thrown open to a general expansion both of credit and of aggregate spending in the private sector. This cast added fuel on the fires started by the first two factors listed.

(d) *The international policy of Soviet Russia.*—This compelled us to resume gigantic defense spending of all sorts, with and ever since the Korean war, in amounts which in recent years have exceeded 10 percent of our entire national product.

(e) *Congressional policies.*—The Congress, with the acquiescence of the executive branch, has in general liked to spend, as on rivers and harbors, housing, highways, veterans' bonuses, farm-price support schemes, and subsidies to shipping and air transport. But it has not been nearly so eager to raise taxes high enough to cover all this and defense spending too, let alone enough to reduce the Government debt. Indeed, tax rates have been substantially lowered; and the gross Federal debt, including business-type activities, is now some \$50 billion larger than at the postwar low, in 1948.² Moreover, the total money volume of Federal Government expenditures has more than doubled since 1948, and is now some \$37 billion per year higher than in 1948. Most of this, of course, is the increase due to defense spending, but not all of it. Even had the budget been kept balanced, this great increase in Federal spending—an increase which was an original or independent source of disturbance—could not have been kept from having a tremendous expansionary and even an inflationary effect.³

² But the direct gross debt of the Federal Government proper increased only half as much by roughly \$20 billions.

³ Even if the increases in tax receipts keep pace with the increases in Government spending, so that there is no budget deficit, the effect of the spending is likely to be expansionary. In general, money which is obtained from taxes is spent, and is spent quickly. If Government spending and tax receipts are balanced at much lower levels, however, so that more money is left in taxpayers' pockets, there is no assurance that the taxpayers will spend correspondingly more than they did at higher tax levels: They may decide to wait and see—to hoard, thus reducing total current sales and output. The expansionary effect of higher Government taxes-plus-spending disappears when tax rates get so high that they discourage private economic incentives, but there is no evidence that this has happened on any large scale in this country, despite all the complaints.

(f) *State and local government spending.*—This is smaller in total than the Federal spending, of course, but it has more than doubled since 1945, and is now two-thirds as large as the Federal total. In the same period the combined debt of the non-Federal government bodies has nearly tripled. These operations, too, are an independent expansionary force.

(g) *The great waves of technological innovation and invention.*—In themselves, they need not have led to overall price increases, but they greatly increased the short-run demands for capital goods. Given the generally easy monetary and fiscal policy which has prevailed most of the time since 1946, they inevitably increased the pressures toward expansion and inflation.

(h) *The postwar transformation of the capital markets.*—Since 1945, the financial intermediaries other than the commercial banks—chiefly the life-insurance companies, the mutual savings banks and the savings-and-loan associations—have grown enormously, as is familiar. Their combined assets now exceed those of the whole commercial banking system. Their growth is in itself undoubtedly desirable. But the institutions involved, which are now the biggest collectors and investors of capital funds, can and do escape in appreciable degree, at least for substantial periods, from the types of restraint which the Federal Reserve has sought to impose at intervals since 1951. The effect has certainly been to retard and even prevent contractions in the monetary demand of their customers for investment goods, which might otherwise have taken place; and I believe the effect has also been positively expansionary.

(i) *The great decrease in the liquidity demands of the general public.*—Changes in this demand are most easily measured by changes in the quantity of money which people wish to hold, relative to the volume of business they are carrying on. Specifically, they can be measured, at least roughly, by changes in the ratio between the gross national product and the money stock (currency plus adjusted demand deposits in the hands of the public). This ratio, or the income velocity of money, was at an alltime low in 1945–46, but by the third quarter of 1957 it had risen by 67 percent. This was nearly 3 times as great as the percentage increase in the money stock itself in the same period (26 percent). In itself alone, it would have provided more than enough additional spending power to buy all of the increase in the country's physical output which actually took place after 1945, at constant prices, even had the money stock remained unchanged at the 1945–46 level. This rise in the velocity of money, or (relative) dishoarding, was in large part simply a symptom of the effects of the other factors listed earlier. But in some degree it can perhaps also be regarded as an independent factor, reflecting a real change in attitudes from the pessimism of the 1930's.

(j) *To summarize,* the major independent or original factors in the overexpansion of our monetary demand since 1945 have been: (1) To 1949, the immediate aftereffects of the Second World War, and the policies of the Treasury and the Federal Reserve; and (2) since 1949, Russia's international policy, congressional policies with respect to nondefense expenditure and with respect to the relation between total expenditure and taxation, and State and local government spending. In the last 3 years 27 percent of our national output has

been sold directly to governments. This has been the great primary or independent source of the expansion in our aggregate monetary demand. The effects of technological innovation, the transformation of the capital markets and the change in liquidity demands have also been marked, but they were in the main either of secondary importance, or were symptoms rather than independent causes, serving primarily to reinforce the other factors. The question of whether the Federal Reserve could or should have imposed more restraint than it actually did will be considered later.

2. *Downward inflexibility of many monetary costs and prices*

These inflexibilities are familiar, and need only to be listed. They include such things as rents, taxes, freight rates, and most interest charges; legally set minimum-wage rates; union wages and fringe benefits established under contracts (especially contracts containing escalator clauses, which in large part seem to work only in the upward direction); the customary prices charged for most personal services; and so on through a long list. The inflexibility is not absolute, of course; it is a function of time. In due course contracts expire and obligations are fulfilled, and can be renewed at different terms; and even tax rates are sometimes lowered. In the short run, however, these inflexibilities hinder or prevent price cuts, and hence hinder or prevent the correction of previous price increases that may themselves have been inflationary.

Another major type of inflexibility is that which results from monopolistic or quasi-monopolistic business organization and practice. The most common consequence is what are usually called administered prices, familiar in many industries. The objection to them is not so much that these prices are too high when business demand is booming, but that they are frequently lowered only with a long lag, and grudgingly, when business slackens—thus again hindering the correction of any previous inflationary increases in the general price structure. And outright monopolies, of course, are likely to set prices which exploit the monopoly position in boom times, but which are not lowered much if at all in recession.

3. *"Cost-push" factors*

The so-called "cost-push" factors have been widely discussed, and are regarded by a good many students as being the primary cause of the creeping inflation of recent years. A different view of their nature and of the part they play will be presented in a moment. Some of them are genuine and important, however. The principal ones among them are as follows:

(a) *Union pressure*, for higher money wages and fringe benefits. So far as the increases in wages and benefits are matched by increases in productivity, of course, there is no cost-push. The evidence here is incomplete and even contradictory, naturally suggests different conclusions for different sectors of the economy, and has been hotly debated by both sides. What I have seen of it, however, suggests to me that in general, in most manufacturing, mining, construction, and retail trades, hourly money wage rates have risen somewhat more rapidly since 1949 than has productivity. This is especially likely to occur where unions seriously restrict the admission of new members. So far as wage rates have actually run ahead, there has obviously been a real upward push on costs, except to the limited extent that other

factors of production voluntarily reduced their relative share of the national output. So far as they did not, prices were forced up. If aggregate monetary demand had remained unchanged, however, this rise in prices would have resulted in a decrease in the physical quantity of goods sold, unemployment, and a fall in prices. This did not happen on any substantial scale till the end of 1957, which means that aggregate monetary demand was expanding—as was also shown in earlier sections. How far the increase in monetary demand was itself caused by this cost-push is hard to say, but I doubt if it was a major factor.*

(b) *The lag of productivity increases in most service industries*, especially those providing personal services. These last typically use relatively little capital, and in most cases cannot make much use of labor-saving devices. Yet their wages, while as a rule lower than those in the unionized manufacturing industries, are strongly influenced by the latter and tend to move in similar directions, if more slowly. This provides a strong cost-push to the prices of the products. Again, however, if aggregate monetary demand were not also increasing the end result would be not rising prices, but falling output and unemployment. That this has not happened, at least until the end of 1957, is further proof that monetary demand was itself expanding.

(c) *Changes in the composition of the population.*—(1) The severe effect of the depression of the 1930's on the birthrate is just now beginning to be fully felt. Perhaps 6 or 7 million fewer babies were born in the 1930's than might normally have been expected, and the additions to the work force in the 1950's have been correspondingly smaller. This population gap has created an outright relative shortage of workers in the younger age groups, has made the work force grow much more slowly than it otherwise would, and has been an important factor in increasing the bargaining power of the unions. This genuine cost-push factor is only partly offset by the resulting stimulus to the introduction of labor-saving machinery. (2) Modern medicine has greatly increased the duration of the average life. Hence the proportion of older people in the population is higher than ever before. But older people spend less on new houses and consumer durables than the young, more on services—in which, as just remarked, productivity usually lags. Also, older people as a group contribute less than the young to current new output, and many of course contribute nothing: They must be supported. This population change too hence tends to push the unit costs of output upward.

(d) *The effects of business monopolies and quasi-monopolies.*—These effects, already mentioned, have been widely debated. Monopolistic practices obviously raise prices somewhat—that is what the monopoly is for, in large part. That they have had a major effect on prices at large, however, or have contributed much to the progressive inflation since 1946, seems to me doubtful. Their chief adverse effect here has probably been, rather, that they have hindered or prevented price decreases in periods of slack business—as remarked earlier.

* The measurement of changes in productivity is in any event ambiguous in a dynamic economy. Few firms make a single product: products themselves change; and labor-saving improvements in production techniques raise the ratio of physical output to man-hours, without necessarily casting any light at all on the contribution of labor itself to that output.

(e) *To summarize*, there have obviously been a number of genuine "cost-push" factors at work. Of these the chief are union pressures, the growing relative importance of the service industries, and population changes.

I do not think, however, that the cost-push factors have been an important cause of the post-1946 inflation. First, some cost-push elements are almost always present, certainly in periods of generally stable prices and probably even in price recessions. Second, the prices of the things that one firm or individual sells in the market, whether physical goods or personal services, are costs to the firm or individual that buys them. Hence anything that results in increasing the prices of products also increases, ipso facto, the costs of the buyers. It is, in a sense, a vicious spiral. Third, therefore, a "cost-push" is not itself an independent factor forcing product prices up. We must look further for the explanation of "inflation." Fourth, this explanation must obviously lie in the expansion of aggregate monetary demand. If sellers try to put up their prices but monetary demand has not increased proportionately, either buyers will not pay the higher prices, and prices will fall back again; or they will pay the higher prices, but will buy smaller physical quantities. On a nationwide scale, the latter alternative means falling output and unemployment. From 1946 to the end of 1957, however, this did not happen more than temporarily and on a rather small degree. In general, that is, buyers have been both willing and able to pay the higher prices asked, and at the same time to buy the same or even larger physical quantities of products. This was true because, and only because, aggregate monetary demand had expanded. This was the root cause of the 1946-57 inflation.⁵

4. Summary: The causes of the post-1946 inflation and why they were not overcome

The principal factors that contributed to the post-1946 inflation fall thus into three main groups: Those operating to increase aggregate monetary demand, those operating to push up costs of production, and those operating to hinder or prevent downward adjustments of prices. Of these, the root causes of the inflation are to be found, I think, in the factors that have increased aggregate monetary demand. Downward inflexibilities may retard deflation, but they cannot themselves cause its opposite, inflation, and the cost-push factor cannot operate if the market for products—that is, monetary demand—is inadequate. Had aggregate monetary demand expanded only in rough proportion to the contemporary increases in physical output, we would have had no inflation; but it obviously expanded much more rapidly than that. Prices rose, depending on the measure used, somewhere between 50 and 70 percent or more.

This excessive expansion of monetary demand was not a simple process, easily understood. On the contrary, it was highly complex.

⁵ The economists and others who have blamed "cost-push" factors as the principal source of the inflation have also usually assumed, tacitly or explicitly, that what we may call the "effective" money supply—money stock multiplied by its income velocity—is highly flexible. This is the assumption that either the size of the money stock itself or its velocity, or both, will always change in such fashion as to adjust to current market demands at current prices. But this obviously need not be so. In a country like ours, the central monetary authorities and the central government in combination can always, if they wish, restrain or reduce aggregate monetary demand and thus prevent inflation. They may think the price excessive, in terms of the possible precipitation of recession and unemployment, but that is a separate issue.

It was due to a number of different but in the main closely interconnected elements. The first was the inevitable adjustment within the United States after the war and wartime controls had ended. Two others "originated" outside of the United States. They were the response of our Federal Government and of our private economy to, first, the postwar reconstruction needs of the rest of the world; and second, after about 1949, to the ominously growing pressures of the cold war. These factors were basic. But others that were almost as important originated in the United States alone. They were principally the policies of the Treasury and the Federal Reserve to 1951; since about 1948 or 1949, the policies of Congress and the Executive with respect to taxation and nondefense spending; the spending programs of the State and local governments; and since 1951, the inability or the unwillingness of the Federal Reserve to impose more than (by hindsight) relatively mild restraints. Those last four factors we can blame on no one but ourselves.

This interpretation of our recent history thus places the chief responsibility for the excessive expansion of monetary demand in the last decade—that is, after completion of the postwar adjustments of 1946–48⁶—on domestic and international factors⁷ that operated primarily at the governmental level. It seems to me beyond debate that had Congress and the Executive insisted on less nondefense spending of all types, both governmental and quasi-governmental; had they imposed higher rather than lower tax rates; and had the Federal Reserve enforced much greater monetary restraint⁸—had all this been done, the burden of increased defense spending could have been carried without any inflation at all. This is not to ignore the other factors working toward expansion in the purely private section of the economy. Technological advances and the consequent drive toward increased business investment, cost-push factors, the general exuberance of "prosperity," all contributed to the governmental factors and reinforced them, but were far smaller in sheer size and force. If they alone had been in operation we might instead have had, as in the middle and late 1920's, stable or even declining prices. They were certainly not, in themselves alone, the principal cause of the post-1946 or the post-1948 inflation.

It should also be emphasized that while combined congressional, Executive, and Federal Reserve action *could* have prevented any substantial inflation after 1948, no one of them could have done the job alone. Fiscal policy and monetary policy must work together, for either can wreck the other, as both European experience and our own amply show.

⁶ A substantial postwar price increase, of perhaps 20 to 25 percent, would have been inevitable even had the wartime controls been relaxed more gradually. The pressures of foreign and pentup domestic demand, and the tremendous volume of liquidity, were too great for any politically feasible combination of monetary and fiscal policy to overcome.

⁷ The Federal Reserve did check the growth of the money supply (demand deposits plus currency) so that it increased only 26 percent from the end of the war to the end of 1957, whereas in that period the gross national product more than doubled in dollar terms. But a net contraction of some 10 percent would have been necessary to offset the rise in money velocity, to obtain the same increase in real output at constant prices. But the discount rate was not raised above 2 percent until mid-1953, nor above 3 percent until August 1957, when the boom was already over. If the object had really been to restrain an inflationary expansion, these rates can only be regarded as almost ludicrously low.

III. THE CAUSES AND CURE OF THE PRESENT RECESSION

1. *The causes*

The causes of the present recession, which may well turn into a major depression, are numerous and will doubtless be widely debated for a long time. The one thing that is unequivocally clear is that the recession cannot be blamed on either political party alone, or on other nations.

A recession is a decline in aggregate monetary demand. It is therefore tempting to assert that the present decline is simply an "inevitable" consequence of the inflationary overexpansion of monetary demand which has been going on most of the time since 1946, and which was examined at length in part II above. But this is too easy, and it really explains nothing. We need to know what kinds of things it was the demand for which fell off, and why the decline began in late 1957 rather than at some other time or not at all.

Especially since the mild recession of 1953-54, rapid expansion has been widespread through many parts of the American economy, both in monetary terms and in terms of physical output. The most conspicuous areas have been industrial plant and equipment, highways, other State and local governmental construction, housing, and consumer durable goods, especially automobiles. Yet a number of major areas, notably agriculture and the railroads, did not participate in the general expansion or even declined; housing, though at quite high levels even now, turned down after 1955; and some metal prices began to drop as early as the spring of 1956. The expansion, and "prosperity," were thus far from uniform through the economy—as is indeed almost always true even in periods of high boom.

Moreover, it is natural in free-market economies not only that expansion should proceed unevenly, but also that some sectors should at times move ahead too rapidly; that is, should increase their productive capacity beyond the current power of the market to absorb the products at prices that will cover costs and still leave a profit. When that happens on a moderate scale, inventories pile up, prices soften, the current output of finished goods falls, and a period of readjustment follows. The recessions of 1948-49 and 1953-54 were of this character: they were primarily "inventory recessions," did not last long or go very deep, and were soon followed by new periods of expansion. In both cases the recoveries began when inventories, especially of consumer goods, had fallen so low that dealers began to reorder. That brought the desired increases in output, and the recessions were over. The crucial factor was that in both cases the declines in personal income during the recessions were almost trivial, small, so that there was a firm base on which to start the recovery.

The present recession looks to be of a different and more serious character. This is true chiefly because of the consequences, which are only now beginning to appear, of the enormous increases in business expenditure on plant and equipment which have been made in recent years, especially in 1956 and 1957. Their volume then was more than twice as high as the average volume for 1946-47, 10 years earlier, though total real physical output had risen only 43 and 50 percent and population hardly 18 percent. An excessive inventory of consumers' goods can be worked off relatively quickly, without doing much damage, but to work off an excessive supply of productive capacity, espe-

cially in the so-called basic industries, may take years. That is, it may take years for demand to catch up or for idle plant to rust away. But until it does catch up, part of the people who formerly operated the plants, and all of the people who built the additional plant and equipment itself, may be out of work. If that happens, what started out as a mild recession can swiftly turn into a major depression. It may well be true that another inventory recession was "about due" in 1957-58 (they seem to come about every 3 to 4 years), but that the onset of this one has also sparked the beginnings of a much larger and potentially much more serious decline in business investment. The drastic cut-backs in previous plans for expansion, which increasing numbers of firms are now reporting, have most ominous implications, and make it seem almost certain that just such a decline in business investment is already under way. This sounds like the 1929-32 collapse, not like the 1948-49 or 1953-54 recessions.

If all this is true, incidentally, both the cuts in defense spending in 1957, and the increase in the Federal Reserve discount rates of last August, will turn out to have been spectacularly badly timed (though I think they were at most a trigger-mechanism, not the primary causes of the initial downturn).

2. *Identification of our current position*

In order to decide what to do about combating the present downturn in activity, it is first necessary to make as accurate an estimate as possible not only of what has happened in the recent past, but also of what is now happening. The latter estimate determines judgments of how serious the current situation will become in the immediate future, before any corrective measures can take hold, and therefore of how powerful the necessary countermeasures themselves must be.

Identification of the current position, however, is difficult because there is almost always a lag, and often a pretty big one, in reporting current data. Some prices are reported weekly or even daily, but many production figures come in only monthly, and others still more slowly. Both the student and the statesman are therefore always behind the actual procession. When things are moving rapidly in the wrong direction, this reporting lag itself becomes serious, and must be allowed for.

I think nearly all of the current reports give bad news. There is no point in citing many specific figures, since they will be different by the time this is read. But steel output is down to below 50 percent of capacity, automobile output nearly as much (something like 80 percent of the first-quarter production of cars is still in inventory), car loadings are down 23 percent below last year and still declining, unemployment is at postwar highs, sales of consumer durables have begun to fall sharply, and the hoped-for seasonal spring return in activity never developed. Still worse are the growing reports that the confidence of consumers in any early recovery is beginning to falter as the unemployment totals rise. Worst of all is the increasing evidence, already referred to, that the plans of most business firms for plant and equipment expansion are being slashed back drastically, and not merely once but again and again as the situation gets worse.

The good signs are rather few. It is true that finished-goods inventories are in general falling or already low, but this merely provides

a good platform for recovery if something else starts it.^{*} Product prices are also holding up, and some are even rising a bit, which seems paradoxical in a recession, but the end effect may only be to delay the eventual fall of prices and thus delay the recovery. Consumer spending on so-called soft goods and services is up a little, but this is said to reflect merely a shift from purchasing durable goods, which is caused by the declines in income that have already taken place. The financial structure and the money and capital markets, however, show no sign of strain.

3. A summary judgment: The situation is becoming critical

I see nothing as yet to justify the frequent optimistic assurances that the bottom is in sight, and that business will turn up in the fall.

What seems to me especially ominous is the growing evidence of a general loss of confidence, both among businessmen and among consumers. The reason why this is so dangerous is that a general loss of confidence in the short-run future automatically produces conditions that vindicate the original pessimism. Businessmen spend less on replenishing inventories and on maintaining or expanding plants; they let workers go and pay out less as wages and salaries; consumers spend less because their incomes have fallen; and then businessmen have to cut back still farther because sales are down. It is a vicious downward spiral.

But will not the downward spiral cure itself "automatically" and fairly quickly, as some administration officials assert? Under the present circumstances, the answer is clearly "No." Businessmen will increase their current spending only if profit prospects improve, in consequence of a fall in costs with expected sales constant; or in consequence of an expected increase in actual sales themselves. But many costs are still notoriously inflexible, and sales are still falling. Consumers, on the other hand, will increase their purchases only if prices drop (with their own incomes constant); or if they expect their incomes to rise; or when their durable goods wear out. But again none of this is happening. In other words, no "automatic" increase in private spending can reasonably be expected in the near future; and the collapse in business investment is making the current situation steadily worse, not better. Only some powerful stimulus originating outside the private economic sector can bring any early improvement.

Moreover, to make things worse, even after a major decision to take corrective action is reached it requires a considerable time for the effects of the action to be felt. Meanwhile the general situation is likely to deteriorate still farther, and the job of curing it then gets still bigger and more expensive.

On all these grounds, I am gravely concerned, and I urge the committee to propose action on a major scale at the earliest opportunity. Every day that passes both increases the danger of disaster, and increases the cost of warding it off. I am unable to find any substantial body of facts that can justify the bland reassurances which the administration has been doling out, and I deplore the administra-

^{*} The fall in manufacturers' inventories began in the latter part of 1957, but sales began to fall definitively after July 1, and are now falling substantially more rapidly than inventories (Department of Commerce, Business Statistics, April 4, 1958). This is extremely ominous.

tion's inertia. Its attitude has a horrid similarity to that of the administration in 1930.

4. Why reversing the business decline is crucially important.

There are two great reasons why the business decline must be stopped and reversed. One is obvious. A serious business decline, in a society like ours, brings falling personal incomes, serious unemployment, and in the end, grave human suffering. The scars of the depression of the 1930's are still fresh in the memories of most of the older generation of today. The apparent willingness of a leading official of the administration to accept a condition of fairly serious unemployment all through 1958⁹ seems to me at once inept and extraordinarily callous. It is not he who will be forced on to the unemployment benefit and relief rolls.

The second is even more important. A serious business decline here will drastically reduce our imports of goods and services from other countries. They fell by more than one-third in the short though sharp recession of 1937-38, and by 70 percent from 1929 to 1932. Any such collapse will have violently adverse effects not only on the economies of our trading partners but also on our international political position. This last is what is really grave about our own business decline. If we cannot buy from our allies in the cold war and from the so-called neutrals, they will in sheer self-defense turn to the Iron Curtain countries; the psychological and political consequences will be disastrous; and we can easily lose the cold war itself without ever firing a shot.

5. Remedies for the business decline: A combination of measures

The decline is a decline in aggregate spending, and what is required to cure it is a substantial and sustained increase in such spending—in aggregate monetary demands. That much is obvious. The practical problem is to select the measures or combination of measures which will produce a really substantial effect in the shortest possible time.

Three main types of measures have been proposed: Tax cuts, increased Government spending, and monetary policy. Each has notable merits, but each also has serious defects.

Tax cuts can be instituted quickly, but from the point of view of their effect on aggregate spending are "permissive" only. They create the possibility of increased spending, but cannot guarantee that it will take place. The beneficiary of the cut may merely use his increase in take-home pay or in after-tax profits to pay off debts, or to hoard against a rainier day. Also, the individual or firm with no current tax liability (and that includes all the unemployed) gets no benefits at all. Monetary policy is also permissive alone. Even at zero interest rates, businessmen will not borrow unless they see a prospect for profit. Finally, increased Government expenditure is ipso facto an increase in aggregate spending, but in most cases considerable time is required to get the necessary arrangements set up, and still more time before the full effects are felt. Meanwhile the business decline gets worse.¹⁰

⁹ Secretary Anderson as reported in the New York Times, April 6, 1958.

¹⁰ Note that the so-called automatic stabilizers, of which so much was made in other years, operate to slow down a decline in business, and perhaps to limit it, but of themselves alone are unlikely to start a recovery. Decreased tax liabilities do not encourage expansion, if income itself is falling still more; unemployment benefits and relief payments are usually smaller than the income previously earned; and so on.

As a practical matter, I think a combination of all three types of measures is essential. No one type alone will both do the job and do it quickly enough. A combination of selected measures, however, will enable each to reinforce the others and will also have a spectacular effect on general confidence, and thus reduce the required strength of the measures themselves. I shall therefore list briefly the particular steps that seem to me most promising, and then consider how powerfully they must be applied. This last is most easily gaged by their probable combined effect on the Federal budget.

(a) *Tax cuts.*—If tax cuts are to be effective in stimulating spending they must be substantial, and with no strings attached at the time. That is, the duration of the cuts should not be specified in advance. To do so would throw away most of their psychological impact value. Not until recovery is well underway should the question of revoking the cuts be raised. I propose these steps:

(1) Personal income tax: (i) Cut the rate on the first \$10,000 of income heavily, say, by 50 percent; (ii) implement this cut by immediately stopping all withholdings of taxes on the first \$10,000 of income, leaving any tax due on this first \$10,000 to be paid by the individual with his quarterly or annual payment of estimated tax.

(2) Corporate income tax: (i) Remove all restrictions on the rate at which business firms may charge off against income those expenses which are actually incurred for repair and replacement (this will provide a strong incentive to increase such expenditures); (ii) raise the level of business income at which the full rate applies to \$50,000; (iii) cut all rates somewhat, say, by 10 percent.

(3) Excise taxes: cut heavily, by 50 or even 100 percent those taxes on products whose output it may be especially important to stimulate, such as automobiles, provided dealers or manufacturers can be prevented from absorbing any of the cut. This is a discriminatory proposal which may be hard to administer, but may be justified in the present emergency.

(b) *Monetary policy.*—The steps to increase monetary ease which have been taken to date are small at best. The Federal Reserve should: (i) Cut the discount rate heavily, perhaps to 1 percent; (ii) cut member-bank reserve requirements to the statutory minimums; (iii) buy both short- and long-term Government securities in the open market until the yield on long term drops to around 2½ percent, which seems to be roughly the historical minimum.

(c) *Increasing Government expenditures.*—This is the one sure way to bring about an increase in aggregate spending. The Federal Government, it is true, has already taken a few small steps. Defense and space programs have been somewhat expanded and speeded up; so has highway construction; and a new program of loans for community public works is now on the floor of the Senate. These total perhaps \$5.6 billion; but by no possibility will that money all be spent in 1958. A new housing bill has also been enacted for some \$1,850 millions, but this is chiefly for the purchase or guarantee of mortgages, not for direct spending; private enterprise must initiate each project.

All of this is good as far as it goes, but it is on a pretty small scale relative to the size of our gross national product, which in 1957 totaled \$434 billions. Much more is needed. I suggest the following additional steps:

(1) Federal aid to the unemployed: Most State programs for paying unemployment benefits run for between 26 and 39 weeks, and then stop. In many individual cases, payments have already expired. Thereafter the unemployed person can only turn to local relief payments, at a still lower level. As a powerful antirecession measure, the Federal Government should pick up the burden when State aid stops, and should continue unemployment benefit payments until the recession emergency is over. This is a particularly effective way of stopping further contractions in aggregate spending, and can be started at once. Proposals to this effect are already in the congressional mill.

(2) Greatly increased aid to State and local governments for schools, hospitals, slum clearance, highways, and other projects of high social value. Such projects give relatively large employment in the urban areas and to the basic industries where unemployment is generally now most severe; the backlog of genuine need is enormous; and in many cases the necessary plans are already largely drawn: they would have been implemented long since had financing been available. The aid should take the form of both: (i) Direct Federal participation, up to 100 percent where local resources are currently inadequate; and (ii) the purchase of State and local government bonds, where debt limitations permit, at nominal interest rates, thus giving the Federal Government financial assets in return for its outlays.

(3) Greatly increased foreign aid, both loans and grants: This will give a powerful direct stimulus to many types of American business, will bring enormous international political gains, and will help offset the effects of the impending decline in American imports. Large additional programs can be put into action relatively rapidly.

(4) Increased defense spending: Both its merits as an anti-recession measure and its urgency for military reasons seem self-evident. The only defect is that in the present state of military technology, it is not likely to produce spectacular and early increases in employment per dollar spent.

(5) Increased appropriations for harbors, river improvement and the like: This is politically appealing, but as an anti-recession measure is at the bottom of the list. The resulting increases in employment usually appear only in limited areas far removed from the present centers of unemployment, and are not large per dollar spent.

(d) *Summary: How powerfully should the preferred measures listed above be applied?*—The best combination of measures is thus: (1) a heavy cut in personal income taxes on incomes below \$10,000 and a smaller cut in corporate income taxes, plus abolition of the present restrictions on charges to business income for repair and replacement expenditures; (ii) a great easing of monetary policy; and (iii) increased or new Federal expenditure on unemployment benefits, on State and local projects of specified kinds, on foreign aid and on defense. I do not believe that any one of these three sets of measures will alone do the job, but the psychological impact and the direct effects of the three in combination will. Moreover, the greater the initial effect the sooner will recovery start, and therefore the shorter will be the period for which the measures must be continued. They will also be correspondingly less expensive.

This is powerful medicine. How strong the dose should be depends, first, on how great the present danger and need are judged to

be, and second, on more technical considerations of how much action is required to overcome that danger. It is also necessary to keep in mind the question of how severe and lasting the after-effects in later years are likely to be.

(1) The present danger: I have argued above that the present danger is already very grave, and that if no adequate action is taken we may soon find ourselves plunged into disasters like those of 1929-32. Most serious citizens would agree, I think, that if that is really the prospect, no price is too high to avoid it. It is my honest conviction that that is in fact the present prospect.

(2) How much action? Limited and weak action is worse than useless. It breeds a temporary and false sense of security, and when the effects are past the basic situation is likely to be worse than ever. Major emergencies require major counter-blows.

If the decline in our gross national product which developed between the third and the fourth quarter of 1957 continues at the same rate (and it seems now to be falling more rather than less rapidly), by the end of 1958 it will stand at an annual rate some \$40 billions below the 1957 peak—a fall of nearly 10 percent. This would be the most severe peacetime fall since 1929-32, and might raise our unemployment above 12 million. We should act at once, therefore, to offset the decreases in aggregate spending which are now taking place, chiefly in private spending, by steps to bring about other and at least equal increases in Government and private spending combined, that is, by increases in total spending at the rate of at least \$35 to \$40 billions a year. It may not actually be necessary to do all this, for if recovery begins and gets well under way we can decrease or stop the action taken, but we should start off with that goal, and at the earliest possible moment.

Specifically, I propose that we should begin by increasing Federal expenditures at the rate of as much as \$15 billion to \$20 billion a year, and institute the proposed tax cuts and easier monetary policies at once. It can then be expected that the direct and indirect effects of these measures will produce additional increases in private spending at the rate of at least another \$20 billion a year or more; and that would do it.

If these steps proved inadequate after some months of trial, it would be necessary to make them stronger—to spend at a higher rate, and cut taxes further. The only alternative would be a collapse into the disasters of a 1930-32 type of depression. If they succeeded, however, and a firmly based recovery began, they could be gradually reduced and eventually ended.

(e) *The long-run cost: inflation?*—The effect of the proposed tax cuts on actual tax receipts is hard to estimate, because these receipts will fall in any event as business activity and incomes decline. The two factors together, however, might well produce a drop below 1957 levels of \$10 billion to \$15 billion—of which the tax cuts might be responsible for perhaps a half. This plus the proposed increases in expenditures would entail a Federal deficit running at the rate of perhaps \$30 billion a year. This is a horrifying sum, at first glance. But it is less than 7 percent of our present gross national product, and it is only an annual rate, not necessarily a realized deficit. In any event, it would be a cheap price to pay for avoiding another great depression.

The deficit, whatever its size, will have to be covered by floating more Government bonds. That is easy enough—the Federal Reserve and the banking system can always insure their sale. It is argued by some, however, that the long-run effect will necessarily be inflationary, and that this is an even greater evil than depression. The latter assertion, I think, is simply not true. There is no economic catastrophe as bad as a major depression, and in the present world situation it would also bring us an incalculable international political disaster. As to the first assertion, it too need not be true. It is entirely up to Congress and the Federal Reserve. Between them, they have all the power required. After recovery has been effected and a new expansion is well underway, it is only necessary to enforce fiscal and monetary restraint: to cut nondefense expenditure, raise tax rates, tighten credit and thus establish a substantial budget surplus. Then there can and will be no inflation whatsoever.¹¹

To put the matter still more simply, if your house is on fire it would obviously be stupid to limit the amount of water the firemen can use because you fear water-damage to the house itself. Without enough water, there may be no house left to worry about.

IV. LONGER RUN ECONOMIC GOALS, AND MEANS TO ACHIEVE THEM

1. Goals

Most people are fairly well agreed by now on the major goals at which general economic policy should aim. The goals are: (i) The maintenance of reasonably full employment, (ii) the maintenance of substantial price stability—that is, the avoidance of both inflation and deflation, more or less as defined in section I, above; and (iii) the maintenance of economic freedom. The meaning of the first two is clear enough, though precise technical definitions may differ somewhat, but the meaning of the last is less unequivocal. To avoid getting into philosophical disputes, we may take "economic freedom" to mean as much freedom for individuals and firms as is thought to be consistent with other goals the society may also have set, and to which it gives a higher priority—such as the protection of women and children in factories, the maintenance of competition, and the like.

The three major goals themselves, however, may also not be mutually consistent in all respects. In a given country, and with a given set of policies and control instruments, it may at times be impossible as a practical matter to achieve full employment without also incurring a measure of inflation (as in France at various times since 1946); or impossible to achieve price and exchange rate stability without also forcing serious unemployment (as in Great Britain in the 1920's). And it may be impossible to achieve both full employment and price stability simultaneously, without trenching rather heavily on economic freedom.

In the United States, our record in these respects over the last 30 years and even over the last 12—since the end of World War II—has not been very good. The depression of the 1930's was a major disaster. Even since 1946, we have had a 60 percent rise in consumer

¹¹ A government deficit incurred to bring aggregate spending back up to something like full-employment levels is not inflationary at the time it is incurred. Conversely (see a footnote in pt. II-1-e, above), even a balanced budget can be inflationary if government spending is increasing when employment is already high.

prices, two medium-sized recessions, and now, I fear, the beginnings of a real depression. Yet I think we can do a great deal better. I think we can combine the maintenance of high employment and price stability all or nearly all of the time; yet without making any substantial new inroads on economic freedom. To do this requires little that is novel. Rather, it requires chiefly only the intelligent and conscientious application of the knowledge and the instruments which we already possess. Few new principles or new apparatus are necessary. The argument is as follows.

2. Means to achieve the goals

The controls over the general level of operation of our economic system are of two sorts, which may be described respectively as automatic, and discretionary or optional. In a free-market economy, both are necessary.

(a) *"Automatic" controls.*—Of these the most important are the tax system and the social security system. They are "built in" by existing legislation, and operate without any further discretionary action by anyone. As business and incomes expand, tax liabilities increase, and exercise a restraining effect on further expansion. Social security payments also become larger. When business and incomes contract the opposite happens, and in addition the burden of unemployment is lightened, though not removed, by the payment of unemployment benefits. The defect of these automatic controls, however, is that in themselves they only exercise a braking effect, important though it may be. They alone can neither stop an overexpansion, nor start a recovery after a recession. For this, discretionary controls are also necessary.

(b) *Discretionary controls.*—Of these, the most frequently discussed are those exercised by the Federal Reserve in the form of monetary policy, and by the Treasury in the form of debt-management policy. By all odds the most important in the United States today, however, is the control which Congress and the President exercise, sometimes almost unconsciously, by varying the size of current Federal appropriations and expenditures, and by varying the coverage and rates of taxation. The average Congressman is likely to think of appropriation bills in terms of their effects on the economic interests or the political convictions of his constituency, not in terms of their effects on aggregate spending; and to think of taxation only as something that people dislike (except that tariffs are likely to be popular). Yet Federal taxation and expenditure are now by far the largest single independent or primary component of, and source of change in, aggregate monetary demand. They are independent, that is, in the sense that decisions about them do not necessarily depend on what some other group decides to spend or not spend.¹²

(c) *Specific proposals.*—To make the discretionary and quasi-discretionary controls work more effectively, I propose the following simple steps, all or most of which require legislation.

¹² State and local government financial operations are also extremely important, but it would be almost impossible to vary them deliberately in the aggregate with a view to influencing general economic conditions in advance—that is, to use them as a policy instrument.

(1) Amend the Employment Act of 1946 and the Federal Reserve Act to make price stability, appropriately defined, a major objective both of the Federal Government proper and of the Federal Reserve.

(2) Amend the Employment Act, or enact other legislation, to recognize formally the desirability from the point of view of the national interest of having substantial budget surpluses in times of general business expansion, and deficits in time of serious contraction. Deficits are not a road to perdition, if they are offset by equal or greater surpluses later. Congress must educate its own Members on both sides of this proposition, especially with reference to the need for decreased spending and for budget surpluses in times of general expansion.

(3) With respect to the Federal Reserve System, there are a number of measures which I think would substantially increase the effectiveness of its policy decisions, as follows: (i) Require all commercial banks, appropriately defined, to become members; (ii) place the Federal Deposit Insurance Corporation under the Federal Reserve, and abolish the national banking system as such (since the note-issue privilege was abolished it has ceased to have any real reason for existence);¹³ (iii) revise the present reserve requirements, as the Federal Reserve itself has now proposed, to include vault cash; to arrange the assignment of particular banks to a particular reserve category on a less irrational basis than that now in force; to abolish the present discrimination against New York and Chicago; and to give the Federal Reserve more discretion in individual cases; (iv) reinstate permanent discretionary control by the Federal Reserve over consumer credit and real-estate financing; (v) authorize and instruct the Federal Reserve to conduct open-market operations in the long-term as well as the short-term markets, whenever the former fail to respond adequately to measures of monetary policy¹⁴ (for this it may be necessary to increase the capital funds of the Federal Reserve banks).

(4) Create a National Economic Commission to coordinate, in the light of the goals outlined above, the policies and actions of the Federal Reserve, the Treasury, the Budget Bureau, and other independent or quasi-independent agencies of the Federal Government that have financial or fiscal power; and give the Commission the power to enforce its decisions on these agencies and departments. Multiple sovereignty in financial matters has become a luxury we can no longer afford.

(5) Give the Commission the power, with the consent of the President, to raise or lower any Federal tax rate by say 10 percent each way, as a countercyclical device.

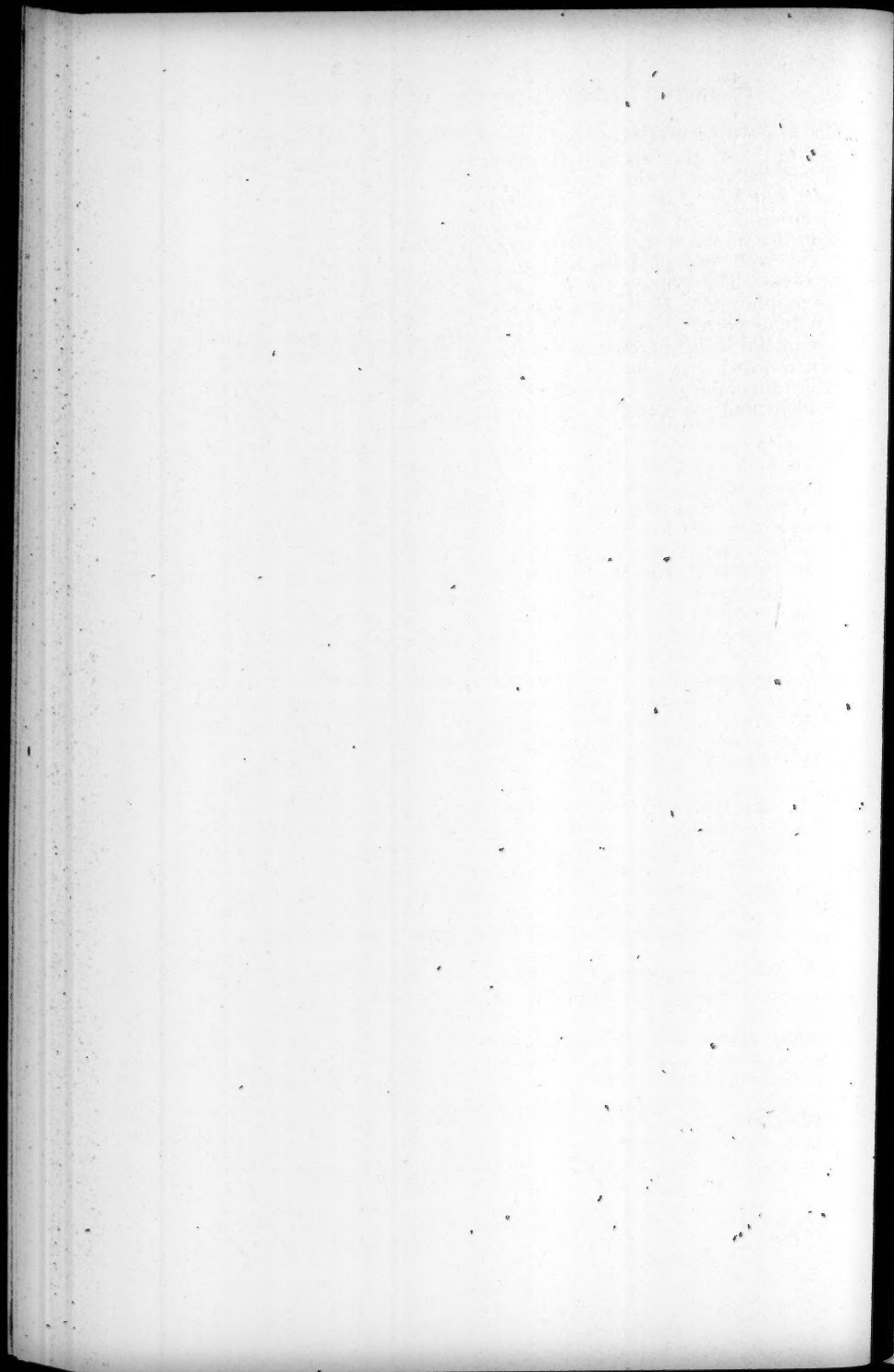
(6) Finally, a more venturesome suggestion, I think the proposed National Economic Commission should be given a substantial standby fund, perhaps as large as \$20 billion, to be used when needed, with the consent of the President, as an antirecession measure. This fund might be set up merely in the form of an authorization to the Treasury to sell bonds for the benefit of the Commission on its request. The Commission should be required to keep an adequate stockpile of

¹³ This will also reduce the number and expense of bank examinations.

¹⁴ I am not impressed by the contention that this would increase the uncertainties and general misery of life for Government bond dealers. Even if it would, the price seems small relative to the probable gains.

plans and projects always ready for use. This would avoid the long delay in taking the first important antirecession measures, which special congressional action for such purposes necessarily entails.

(d) *The key: The will of Congress and the President.*—It cannot be emphasized too strongly, however, that all of these proposals are essentially no more than devices to help make our economic machinery run well, provided the will to make it run well is there in the first place. The Federal Government and its related agencies already have ample power to make it run well, but they have not always had the will, or perhaps have not always realized that they had the power. No man can legislate his own virtue, and the Congress cannot compel itself to do what it does not wish to do. The key to the achievement of the economic goals described above lies in the Congress and the President, and nowhere else. It is up to them.



UNIVERSITY OF ILLINOIS,
BUREAU OF ECONOMIC AND BUSINESS RESEARCH,
Urbana, April 17, 1958.

HON. HARRY F. BYRD,
Committee on Finance, United States Senate, Washington D. C.

DEAR SENATOR BYRD: In accordance with your request of February 17, I am enclosing a statement entitled "What Should Be Done About the Recession."

Although complete answers to all your questions are not provided in this statement, all of them are at least partially dealt with. I trust you will find this a useful contribution to your "Investigation of the Financial Condition of the United States."

Sincerely yours,

V. LEWIS BASSIE, *Director.*

WHAT SHOULD BE DONE ABOUT THE RECESSION

The really critical question of the day concerns the causes of the current recession and what should be done about it. A general essay dealing with this problem in a comprehensive and orderly way seems preferable to providing answers to a series of discrete questions. Nevertheless, the relationship of the questions raised to the main theme is clear, and at least partial answers to all of them can be provided in an incidental manner, as indicated by the marginal numbers. It seems entirely appropriate to begin with an attempt to clarify the difficulty of terminology existing in discussions of inflation and deflation.

A certain amount of confusion arises from accepted definitions of inflation and deflation. A period of inflation is usually defined by the movement of prices; a period of deflation is usually defined by other measures of economic activity. This makes it possible for both to exist at the same time. In fact, insofar as prices tend to lag behind activity at cyclical downturns, both must be expected to prevail temporarily in such situations.

These definitions are arrived at negatively, by reference to the "evils" they involve: The evils of deflation are described in terms of unemployment and of losses of income from production, the evils of inflation in terms of the losses in value of purchasing power imposed on holders of fixed capital claims and others with fixed incomes. For this reason, the terms as they are ordinarily used are not direct antonyms, although many assume that they should be. Various definitions could be set up to eliminate this difficulty, but none will be attempted here.

BACKGROUND OF THE RECENT "INFLATION"

In the normal course of economic developments, the price level tends to be determined by the pace of overall activity. The broadest

measures of activity, such as gross national product and national income, represent aggregate demand and aggregate cost; and these are the primary determinants of prices. However, the interactions are such that price changes may themselves become determining at times and induce changes in investment and in overall activity.

There are, in other words, periods of exceptional speculative activity when profits may be realized from the price movement and the inducement to borrow as a way of realizing such profits is strong. In such situations, prices are bid up more than would be justified by the underlying, "real" conditions of the economy; the pace of activity is fast enough seemingly to justify the price movement; and optimistic psychology feeds on both the price advance and the strength of "trends" in investment and output.

When such a movement occurs at the end of a long period of prosperity, it is usually accompanied by confidence that the boom will run on forever. This infectious attitude seemingly justifies for everyone the adoption of price policies designed to give each the most rapid improvement in his position. In recent years, labor viewed the economy as capable of providing greater security and leisure for workers; it pressed for wage increases large enough to give it all the gains of increasing productivity, not only in money but in real wages. Industry felt that its markets were strong enough to pass on all cost increases through the application of pricing formulas that would facilitate the financing of the new facilities it considered necessary. Each blamed the other for fueling the fires of inflation. Both were infected with the state of mind that denies restraint in a "new era" of optimistic fervor.

The movement began with recovery from the lows of the 1953-54 recession. The stock market led the way, roughly doubling from the fall of 1953 to the spring of 1956. Wage rates hesitated only briefly in the recession and moved into new high ground by the end of 1954. Consumers began to draw on available credit, which was more freely offered, and on "easier" terms. Housing starts first reflected the stimulus, and construction contracts moved to new highs in the latter part of 1954. Expenditures for consumer durable goods also showed firmness and began a strong upsurge to new highs at the end of that year. The spring and summer of 1955 recorded an unprecedented spurt in auto buying. This touched off in the fall of the year an unrestrained cycle in capacity expansion, which spread with some lag to steel and to other industries. This cyclical upsurge in fixed investment was encouraged by high profits and by the more rapid amortization of facilities permitted in the tax revision of 1954.

It was this boom in all forms of private investment that provided the real basis for the new advance in prices that got underway in the spring of 1956. It is more than a coincidence that the spreading wave of cost and price increases centered in the durable goods industries. In convincing themselves that prosperity was enduring enough to justify all-out expansion, businessmen also convinced themselves that the market was strong enough to pick up the tab. Their attitude toward wages and prices changed. Instead of asking, "How much of a wage increase can we grant without making necessary price increases that will upset the market?" they began to ask, "How much will we have to raise prices in order to grant the wage increases necessary to keep from getting shut down?" The strike in steel was not avoided, but

its main effect was to reduce inventory holdings that might otherwise have had a restraining effect. This change in business attitudes in the early part of 1956 roughly coincided with the reversal of the steady decline in farm prices from the Korean war peak.

A minor contribution to the price advance, and to its lag behind activity, was made by the cost-of-living adjustments in wage contracts. The more widespread these escalator provisions become, the more unstable the price level will become, and the greater will be the speculative component in the business cycle. At the extreme, when all prices are subject to escalation, a high degree of instability might be engendered by temporary, exogenous price changes, such as changes in farm prices resulting from unusual weather.

CREDIT FACILITATED THE BOOM

Debt expansion placed a significant role in financing the boom. All forms of private debt—mortgage, long-term business, bank loans, and consumer installment credit—expanded sharply through the postwar period, and, in most cases, the movement accelerated in 1954 or 1955. This use of credit facilitated the reaching of extreme heights during the boom, from which any reaction might be correspondingly severe. It also threatens in the current recession to aggravate the severity of the decline by diverting purchasing power from current expenditures to liquidation of debt.

State and local government programs were also facilitated by debt financing. During the mid-1950's, annual State and local security issues reached a level about four times the peak rate of the 1920's. Throughout the same period, State and local expenditures have moved up at a rate of \$3 billion a year. The continuation of this movement into the current recession period represents a stabilizing force, though one of limited magnitude in a \$440 billion economy. Moreover, the prospect that the advance cannot continue if declines in sales, incomes and property values adversely affect State and local revenues—and, more serious, that even the current rate of expenditures cannot be maintained under such conditions—has ominous implications with respect to the ultimate extent of the decline.

Federal Government debt, alone, did not rise substantially in the postwar period. Modest liquidation in the early years was reversed by the Korean outbreak, and, after the cutbacks in military expenditures in 1953, small budget surpluses were again realized. Cash surpluses were substantially larger. The gross debt rose to a new high only because of substantial accumulations in trust funds. There was, in other words, no significant contribution of deficit spending since the end of World War II to the boom or to the inflation experienced in its course through 1957.

This does not mean either that Federal expenditures played no role in the boom or that such expenditures financed by deficits can play no important role in the recession. They, like State and local expenditures, are playing a stabilizing role in the current recession. Unlike State and local, Federal expenditures may be expected to continue rising as the decline progresses. But it is unlikely that this one segment can produce a total sufficiently large to offset entirely the downward phase of a major business contraction. Nor, as is indicated below, should it be expected to do so.

The monetary-control policies of the Federal Reserve System had no important effects on the overall economy during this period. In the first flush of enthusiasm after the accord of 1951, monetary tightness was permitted to progress a little too far. This may have had some mildly depressing effects, particularly on residential construction, and, thus, contributed in a minor way to the recession of 1953-54. But it was not important in comparison with the other depressing influences at work at the time, and the prompt reversal of policy in the fall of 1953 corrected any such tendencies.

In the later period of "tight money," covering roughly the 2 years to its culmination in the fall of 1957, the "controls" contributed little to the results experienced. The impact of extraordinary demands for credit to finance the investment boom produced what was, by postdepression standards, an extreme stringency in money and capital markets. The bidding up of interest rates to new highs for a quarter century represented the operation of "natural" or "purely economic" forces.

Contrary to popular impressions, Federal Reserve policy was extremely cautious. All it did was hold Federal Reserve credit stable. It neither condoned the excessive borrowing and spending nor took away any of the resources available to those engaging in such activities. True, rediscount rates were raised in a series of steps, but in each case the market rate on Treasury bills had come up to the level established earlier before a new advance was made. A good case can be made that a more restrictive policy should have been adopted in the latter part of 1955, and pursued aggressively with the objective of cutting the top off the investment boom. It must be admitted, however, that such a policy would have encountered strong opposition.

It follows as a corollary of this view that Federal Reserve policy is not significantly responsible for the current recession. Looking backward, it might be said that earlier easing would have been desirable, before the recession got underway in the fall of 1957. But this, too, would have encountered strong opposition. The first actions toward easier money were actually taken at a time when prices were still rising and the economic and business consensus was still optimistic.

NATURE OF THE POSTWAR INVESTMENT CYCLE

The recession was not brought on by resistance to price increases or by any conscious change in monetary or fiscal policy. Its direct and only important cause was the collapse of the investment boom. The suddenness of this collapse and the speed of the decline to date are due partly to the speculative elements that became so important in 1956. This is the typical conclusion of a long period of prosperity, as was noted by Wesley Mitchell a generation ago.

During recent years, evidence has been piling up that the postwar boom was approaching its culmination. Every major war has been followed by high prosperity, and every postwar boom has been followed by a severe depression. The recession now in progress is the early phase of that kind of major contraction.

The forces that produce these results are not accidental. The cycles in various components of private investment derive from a succession of imbalances on two levels: First, there are imbalances in the position of stocks—that is, stocks may be either excessive or deficient. Second,

there are imbalances in the flows—that is, the rate of production may exceed or fall short of the current rate of consumption.

Postwar cycles are the most vicious kind of cycle. The economy inherits from the war imbalances on both these levels. Stocks and production are both too low at the end of the war. Business needs larger inventories. Backlogs of demand for consumers' durable goods are high, and people have large accumulations of liquid assets to make their demands effective. The stock of houses is inadequate in relation to the need for living quarters. Business rushes in to take advantage of this unusual opportunity. It needs new plant and equipment to do the job. All these deficiencies bring on the boom, and each phase of the cycle then follows as the logical consequence of that which preceded it.

To remedy the initial deficiency of stocks, production must be lifted above the level of current demand. This succeeds after the passage of an appropriate period of time; the deficiency is made up, bringing stocks to the desired level.

But note that the price paid for achieving this result has been the unbalancing of the flows. Production is running well above consumption and must be cut back to the level of demand to prevent excesses from appearing. But making this adjustment brings on the very excess it was intended to prevent. Stocks continue to advance until the excess of production is eliminated, but, by then, incomes and demand are lower, so that the existing stocks are excessive in relation to the new level of demand.

This excess has to be eliminated by unbalancing the flows in the opposite direction. That is, production has to be cut to a point below consumption to work off the excess, and activity is thus forced down into depression.

This mechanism works quite differently in the various segments, depending primarily upon differences in the time periods required by the processes of production and consumption. It is rather symmetrical in the case of business inventories as such, because periods of production and consumption are short. It is long drawn out in the case of housing and productive facilities because the processes of production are long drawn out and the processes of consumption are even slower. Stocks of structures hardly ever decline. They just stop rising for a while.

There is one point in the fixed investment cycle that tends to make for extremely sharp changes. That is just after a downturn, when the two kinds of imbalance are working together. Today we are in such a situation. We have both excess capacity and a rate of new investment too high to be sustained. The excess capacity is not confined to industries like steel, where demand has declined; it has appeared in other industries whose demand has remained stable at high levels, because their capacity has expanded. Furthermore, the recent rate of new investment at \$37 billion is far above the requirements for growth.

These imbalances are working together to depress new investment, and the decline will probably be both severe and long drawn out. Looking ahead, there can be no early adjustment. At the end of 1958, capacity will be higher and production lower. The imbalance of position that is helping to force the current decline will be worse at that time. It will tend to force a still larger decline in 1959.

Moreover, business inventories have been in much the same position in recent months. With the recent decline in sales—and this means sales in physical volume terms, not in current dollars—inventories are excessive and have to be liquidated. The rate of liquidation will tend to increase in irregular steps as long as sales recede. All forms of business investment will be driving the economy toward depression.

Can we hope that autos and housing will come to the rescue, as in 1949? This seems to be a futile hope. Those segments are governed by the same kind of cyclical forces, and their position has basically changed since 1949. There are no longer any backlogs of unfilled demand. On the contrary, both have been approaching the point of market saturation during the last 2 years.

It is evident from this that the current recession represents an unusual situation—the kind of conjuncture of deflationary forces that is encountered only in the downward phase of a major cycle. In considering remedial action, the first thing to be recognized is that the measures applied in unusual circumstances should not necessarily be the same as those adopted on other occasions. To apply measures that cannot succeed may merely discredit valid instruments of control whose use would suffice in situations to which they are appropriate.

LET PRICES TAKE CARE OF THEMSELVES

In these particular circumstances, the essential distinctions tend to be overlooked. There is a seeming identity between goals of stability and of growth; for the decline in employment and production has to be halted before growth can be resumed.

Considering these two objectives in more general terms, it might be said that the primary distinction between them lies in the time perspective: Over the long run, there is a strong desire for progress; in the short run, there should be sufficient stability to rule out interruptions to the steady gains by which progress is achieved. There could be no justification for any kind of stability that would prevent growth; but a temporary rate of growth so rapid that it must collapse into instability is also undesirable.

To add price stability as a third objective is to confuse the issues. There are situations in which rising prices cannot hold the implication that anti-inflationary action is needed. We are in one of those situations at the present time; action to halt the decline is called for despite the fact that prices continue high. Another such situation typically arises during recovery from the depths of depression; then, prices should be recovering long before unemployment has been reduced sufficiently to render further Government action to stimulate the economy unnecessary.

There are many lag elements in the Consumer Price Index. Rents, utility rates, and prices of many services do not adjust quickly to a change in conditions. Seasonal effects on food prices such as the unfavorable weather conditions of the last few months, hold few implications for stabilization policy. Differential price movements of this "uncontrolled" character might be either retarding or stimulating. Those of recent months call, if anything, for greater antirecessionary action, because the high prices for necessities drain consumer purchasing power from the industrial sectors of the economy in which unemployment appears.

Price changes should be considered symptomatic of underlying conditions rather than a basis for action in themselves. If there is a margin of resources available—and throughout the recent period of “inflation,” unemployment continued at 4 percent—prices will be taken care of by the undirected responses of the economy. The increase over the past 2 years has been very moderate for the prevailing situation and holds no threat of continuing or all-out inflation. The most effective protection against inflation lies in the excess capacity and the surplus labor now looking for customers.

Furthermore, mere price stability does not indicate a satisfactory state of affairs. Economic movements can get under way in either direction, and even get out of hand, before the price indexes show a definite response. The late 1920's comprised a period of exceptional price stability. Price stability also persisted throughout 1955; and finally we are now witnessing the false impression given by the divergent movements of recent months. Thinking we have achieved some kind of millenium when prices are stable may merely be a way of ignoring underlying conditions that will make prices move, and perhaps violently, at a future date.

From the longer term point of view, it seems clear that the economy can work well with prices, within limits, either rising or falling. Perhaps the minor stimulus obtained from gradually rising prices is to be preferred, since our resources and productivity are so high as to engender a tendency toward chronic unemployment. Nevertheless, the most satisfactory results are likely to be obtained in the absence of efforts consciously to steer prices in either direction.

As long as the economy shows a margin of unutilized productive resources, therefore, the only action needed on the price front is to insist on the maintenance of reasonably competitive conditions, including competition from abroad. Then prices may be permitted to take care of themselves; the essential freedom of individual prices to move will be preserved; and economic policy need not be contorted by endless wrangling over contentions arising from conflicts in stated objectives.

THE BASIC OBJECTIVE OF ECONOMIC POLICY

The real goal of all our efforts should be a system of control over economic fluctuations. Only if there is control can we be assured of both the progress implicit in the long-term goal of growth and the avoidance of wide cyclical swings implicit in the short-term goal of stabilization.

Unfortunately, the control mechanisms that have been developed to date do not appear to be fully adequate to the task. The lack of effectiveness of monetary policy for stopping recessions has been amply demonstrated. The difficulty here is that offering loans at lower interest rates cannot expand borrowing at a time when potential borrowers see no way to profit by the use of the funds. Once the reins are fully eased, pushing them out further doesn't necessarily make the old horse go faster; and dropping them entirely may have just the wrong effect. Other means of increasing the pace then have to be applied.

The most widely held view of how to go about this holds that the Federal Government has accepted the responsibility and now has to live up to it. The presumption is that any necessary adjustment can

be made by suitable applications of the powers of its fiscal policy twins—tax reduction and increased expenditure. The former operates by leaving additional purchasing power in the hands of the public, the latter by stepping up activity in the specific areas to which the expenditure programs are directed. Both have the effect of increasing the deficit, and to the extent that the newly created debt is held by banks, of increasing the money supply.

Frequently overlooked is the fact that there are dangers in the use of these powers. The dangers inhere not only in the evils of inflation and deflation, but also in the changes that might be wrought in the social and political structure of the economy by intemperate action. It is hardly ever contemplated, for example, that the Government should take over the entire function of investing in capital goods; but to keep the economy completely stable might imply investing in such goods to an extent that private industry would never regain this function.

The effective use of any kind of controls requires knowledge, skill, and a sense of timing. The pilot of the airplane has controls adequate to make the plane do what he determines it should; but the novice may crash the plane by overcorrecting in a situation that calls for a delicate response. If his reactions are either panicky or delayed, he may never make a good pilot. Even if he qualifies for a license, there may still be circumstances in which it is unsafe for him to attempt a trip. Adverse weather conditions keep many flights grounded. There are certain analogous circumstances in the application of economic controls.

Just knowing when to act is important. The point is illustrated by the recent shift, in a period of about 6 months, from determined efforts to combat inflation to all-out seeking for means of stopping the recession. This veering about of attitudes and approach reflects not only the reversal in business but the limitations of economic know-how. It calls attention to the need for a policy determination as to suitable control points for compensatory action. The best of our stabilizing devices in other fields—thermostatic or mechanical—have limits of tolerance within which controls do not operate. Unless we can view the economic situation tranquilly within similar limits, action may increase rather than moderate instability.

Perhaps the best indicator of the need for action is unemployment. The first postwar decade indicated that unemployment may fluctuate over a fairly considerable range without changing the basic situation. During this period, the seasonally adjusted rate of unemployment varied within a range of 3 to 6 percent of the labor force. It is not unreasonable to regard this as an appropriate range of "no action" in unemployment policy. This should prevent intemperate action that could subsequently prove self-defeating. Some of the things that may be done to prevent a decline can only be done once; and if they are done at a time when unemployment is still moderate, part of the ammunition that might be used to compensate a much more serious setback will have been expended. Moves made in recent years to stimulate home buying on minimum terms and business investment on maximum writeoffs have precisely this unfortunate aspect at the present time.

When unemployment rises above 7 percent, as it has, there can be no serious doubt that it is time to get busy. Unless preparations are made for something still worse ahead, action will not be speedy enough to meet the need. Certainly by the time unemployment reaches 10 percent, measures of an all-out character should have been made operative; and as long as the rate remains above that level, efforts to bring it down must be unremitting. Nevertheless, reasonable care in the administration of stimulants is essential.

SOME FALLACIES ABOUT ECONOMIC CONTROL

The most dangerous fallacy in current thinking about economic control consists of the widely accepted notion that the Government can and should do whatever is necessary to reverse the decline quickly and bring activity back up to full employment levels. Looking at the available controls in quantitative terms does not suggest that there is any such easy solution. The quantities involved in the collapse of the investment boom are much larger than any Government action now contemplated. Following such a downturn, the major contractions have always been severe and long drawn out. Compensatory action on the scale now required might involve dangers of economic breakdown more serious than those posed by the current recession. The logical application of antirecession measures aims at mitigating the extreme fluctuations between business cycle peaks and troughs but not at maintaining "maximum levels" regardless of the consequences for existing economic and political institutions.

Another fallacious view of the problem consists in the idea that a deficit automatically results in recovery and inflation. This line of thinking overlooks the fact that a deficit may have no immediate effect of this kind and only result in additional stimulation and inflation at a later date when such effects are no longer wanted. A deficit per se tells little about the effects of Government policy on the economy. If it grows merely because receipts from established taxes are falling, it cannot be a positive force for recovery. Its effects have already been built into the multiplier, and all it can do is help moderate the decline. If a deficit resulted from decreases both in taxes at given rates and in expenditures, with the former falling faster, the net short-term effect would be deflationary rather than inflationary. In any situation, the effects of a deficit may be analyzed only by considering the specific types of program and tax changes responsible for the difference between expenditures and revenues.

A related misconception holds that a limited Government stimulus—say, a spending program or tax cut of \$5 billion—will result in a new upswing. Actually, \$5 billion is just \$5 billion. A public works program of that amount will serve as a substitute for approximately the same amount of private construction; if anything, the secondary and subsequent effects will be less because it cannot be regarded as a component of long-term growth. An equivalent tax cut would be bound to produce an even smaller offset, since not all the funds left with the taxpayers will be spent. Neither of these actions could compensate for the projected \$7 billion decline in business capital outlays from last year's third quarter high to the corresponding period of this year.

Another important fallacy is the analogy that compares the economy with an inefficient old pump. If the pump is primed with a little water it becomes operative, suggesting that a temporary stimulus will turn the economy up. This analogy, however, is entirely inappropriate. The forces that move the economy do not become inefficient during a decline. Business is making its usual vigorous response to the conditions that have been experienced, and activity will not come back up again until the underlying difficulties are corrected. There is nothing in our knowledge of economic processes to suggest that a temporary stimulus can produce any enduring change in the level of activity; it might set in motion cyclical swings in the private sector, but even these would probably soon "damp out." This applies equally to a tax reduction with a definite time limit and to a temporary speedup of expenditure programs for which the total outlay is fixed. To be effective in countering the recession, anything that is done should be done with a view to keeping it in effect as long as it may be needed.

Also erroneous is the assumption that maintaining the overall level of purchasing power in the hands of the public will solve the problem. This conception of the problem persists despite an economic commonplace which emphasizes the importance of the gap between purchasing power and purchases; current receipts may be "hoarded" in various ways, for example, by being used for debt reduction. But even if income and purchases were held stable at a high level, the result would not be stability in business investment at a high level. The latter requires growth in demand, not merely stability.

Finally, there is the fallacy that the economy operates on confidence and can be stimulated by optimistic predictions or by promises of future action. Most people are tough minded enough to make their own judgments about what is taking place. False predictions are quickly exposed and then an adverse reaction sets in. Promises not backed by deeds also result in disillusion. There are so many real and financial determinants of business that psychological states of mind ordinarily have little significance. Only in special situations does confidence become important and then by going to an extreme. We have just been through one of those periods at the peak of the boom, and no amount of idle talk can rekindle the excesses. Only recovery and growth into new high ground could do that. Facing facts and doing things can help promote recovery; but hoping that exhortation will get somebody else to do the job is unlikely to accomplish anything at all.

TAX CUTTING HAS LIMITED USEFULNESS

With these brief comments to clarify certain aspects of the situation, the potential value of tax reduction as a tool of economic policy may be considered. The economic stimulus to be obtained from any change in tax rates depends entirely upon the kind of change made. Since taxes come partly out of saving rather than spending, when they are not collected, the proceeds go partly into savings rather than expenditures. Reductions that increase the take-home pay of wage earners are likely to reappear in relatively high proportion in consumer purchases. Reductions that leave more income in the higher income brackets or in corporate accounts are also likely to produce

some additional expenditures, but in relatively small proportion. These differences make it clear that if tax reductions are to be made for stimulating the economy, they should be confined to those best adapted to this end, and not just granted to all who would use the recession as an excuse for getting their taxes down.

It is often asserted that reducing high-bracket taxes will make additional savings available for investment, meaning expansion of real capital. This, however, is very improbable in a recession. The kind of "investment" most likely to be stimulated is investment in the bonds issued by the Government to finance the deficit. A high level of transfers could be effected in this way without any significant effect on activity.

One way to perceive the difficulty with any given total of tax reductions is to assume that tax rates will be left unchanged and an equivalent amount will be given away to those most likely to spend the funds received for goods and services. On this basis, the bulk of the funds would probably go to recipients whose position is such as to exclude them from tax liability, namely, to the unemployed. This line of reasoning leads to the conclusion that there is no tax cut that "best" satisfies both the objective of stimulating the economy and the Government's responsibility for the welfare of that segment of the population whose needs are most pressing.

A limited tax cut will not solve the problem despite the emphasis being placed on the role of such cuts in the recessions of 1949 and 1954. In both those situations, other factors were favorable, and there is no evidence that tax reductions made greater than normal contributions. The stimulating effect of any tax cut is bound to be less than the reduction in Government revenues except as it may tend to stimulate fears of inflation and a flight from the dollar. A modest tax cut of, say, \$5 billion could hardly produce the latter response. If it were somewhat biased in favor of the lower income groups it would probably expand expenditures by \$3 billion to \$4 billion. If it had to be more generally distributed in order to command sufficient support to be enacted, the stimulus would be less.

A large, temporary reduction would produce the least effect of all. Experience indicates that "windfalls" are not spent to the same extent as regular income. A study of the veteran's insurance refunds indicated that the additional expenditures from such payments during the first year amounted to only half of the total received, even though they were very widely distributed, in comparatively moderate amounts. Additional evidence on this point is provided by the "permanent income hypothesis," which specifies that transitory components of income do not affect consumer expenditures to the same extent as the permanent components.

Perhaps the best argument for a tax cut is that once adopted it has almost immediate effects. What the economy needs at this point, however, is not just a quick stimulus, but a sustained effort on a continuing basis, making the best use of available resources.

Another argument in favor of tax cutting is that current tax rates are too high and exemptions too low, having been set in wartime and not subsequently modified to take account of inflation and other post-war changes in economic conditions. The existing rates, however, do not produce inordinate surpluses in prosperity years. They are ap-

parently high enough to cover existing programs if personal and corporate incomes could be maintained near the peak rates. They provide little if any margin for expansion of antirecession expenditures. Furthermore, taxpayers have generally adjusted their activities to the existing rates, so that there is no reason to think that they have unduly depressing effect. Certainly, no such effect was noticeable in the recent boom. A good case can be made for setting rates that will produce a surplus in boom times and for keeping those rates stable through recessions, when reduced yields will result in deficits in any case.

Presumably any tax-rate reduction enacted at this time would result in aggravating the deficit that will have to be financed by borrowing. Since there are substantial leakages in tax cutting, this policy would add more to the problem of Government finance than it contributed to economic activity. It may, therefore, be concluded that tax reduction is the "weak sister" of the fiscal-policy team.

EXPENDITURES MUST BE ADJUSTED TO NEEDS

In considering increased expenditures as the alternative, it is evident that a variety of considerations other than economic effects must enter into program decisions. Some programs that meet needs unrelated to the position of the economy may have to be undertaken even though they will be unstabilizing, and at times such programs may have to be curtailed in a recession. It is impossible to deal with the ramifications of this subject here. Hence, except for specific comments in several instances, the noneconomic criteria for deciding programs are not considered.

Perhaps the one kind of expenditure that could be expanded sufficiently to provide a substantial offset to the recession consists of the military programs. The appeal of this "solution" is supported by the fact that we are engaged in an armaments race with the Russians. After the sputniks, several reports on national security were released recommending program increases designed to give us a preponderance of military power. However, this is also the one type of expenditure for which the best case can be made that programs should be determined independently of economic conditions. This case rests on grounds of moral principles, good Government planning, and international relations. Now that both sides are supplied with H-bombs, there can no longer be any "security" in military power. Decisions to wage all-out war have become, in effect, international suicide pacts.

If the armaments race should be given a push by the desire to avoid depression, the future of civilization may be endangered. The country pursuing this course would be on the road that Hitler took. It is hardly an agreeable experience to choose between war and depression. But a clear preference can readily be formulated: We may still live well if our income is somewhat reduced; we may not live at all if the forces of the atom are loosed upon us.

The kind of antirecession program commanding most attention since the 1930's consists of public works. These projects not only sustain activity by replacing private investment with public but create useful facilities to serve various community needs. The objection is sometimes made that public-works programs are slow and inflexible. However, slowness is relative to the timing of the need, that is, to the

duration of the investment cycle. To the extent that this criticism is based on the "pump priming" concept, it misconceives the problem. The depression phase of the fixed investment cycle is long drawn out, and it is therefore appropriate to utilize a remedy that operates over equally long intervals. The main cause of delay up to this point seems to be reluctance to decide that the program is needed.

A related objection holds that since projects once started have to be completed, public-works programs cannot be curtailed quickly after the need has passed. This, again, is a "month to month" version of the problem which refuses to take the cycle seriously. The fact is that public-works budgets are subject to annual review. They may be curtailed far more readily than tax cuts could be rescinded; it is hardly ever expedient to raise taxes, even during a boom period, when restraint is desirable.

In attempting to meet specific depression needs, public-works programs rely upon a variant of the "trickle down" approach. In the case of tax cuts, the entire reliance is upon secondary and subsequent effects. Public works create a certain amount of direct employment but largely depend upon subsequent reactions to effect reemployment of other workers. In other words, the jobs they create do not necessarily meet the needs of the unemployed workers. Modern methods of construction do not require large numbers of workers. A major speedup of the highway program, for example, would put only a small fraction of the unemployed back to work. Moreover, projects have to be carried out on designated sites, often remote from the surplus labor.

It was mainly for these reasons that the work-relief program was adopted in the 1930's. Projects had to be "designed" to create the maximum number of jobs, requiring the appropriate skills, and this became a community function in order to insure that projects would be created in the localities where workers needed them. Even with the "inefficiencies" resulting from this approach, many of the accomplishments of a true public-works program were achieved.

In times of high unemployment, the Government is also called upon to make direct payments for the relief of hardship experienced by unemployed workers and their families. The welfare of the community demands that a minimum standard of subsistence be provided for those whose incomes are inadequate. Such direct relief payments go as far as possible in preventing diversions into saving, since the application of the means test confines payments to actual current need, but they are generally considered undesirable for reasons of a personal and social character.

Part of the subsistence problem is taken care of automatically by the social security programs. The old age program makes a contribution by providing retirement income for older workers who are removed from active duty, often involuntarily, at an earlier age than in fully prosperous circumstances. More important, the unemployment compensation program provides partial income over periods ranging up to a half year. Originally it was contemplated that this income should be about half of the worker's regular take-home pay, but rates of compensation have not been raised in line with increasing wage income, and in many cases reserves would not be sufficient for payments of that magnitude if the rates had been stepped up. Both of these

programs provide income, not as a form of charity, but as a right earned in previous employment.

The deficiencies of unemployment compensation illustrate again the power of the desire to keep taxes low. It was this desire that led to the adoption of the various experience rating schemes that have kept benefits and reserves at a minimum. Efforts are now being made to put the program on a basis more nearly adequate to the need for income, by making Federal funds available to extend the period of payment. However, any limited payment period, even one longer than now proposed, will leave the basic difficulty. After the initial upsurge in unemployment, benefits dwindle, and the power of the program to counter further recession is lost. Furthermore, there is considerable doubt that any program should confer benefits as a matter of right over an indefinite period. The application of the means test in relief derives from its ability to conserve resources; transfers beyond actual needs are not desirable.

HOW MUCH SHOULD THE GOVERNMENT DO?

What emerges from this brief review of alternatives is that none of the measures available to Government for compensating economic fluctuations is wholly free of objectionable features, and these make each the subject of controversy. This no doubt accounts in part for delays and indecision in moving to head off a decline during its early stages. Nevertheless, it seems clear that the Government can do much and that it should use its powers as effectively as possible to minimize depression difficulties and promote recovery. This generally accepted view, which was incorporated in the Employment Act of 1946, is founded upon international as well as domestic considerations.

Agreement on these principles does not mean, however, that efforts to reduce unemployment and promote recovery can or should be expanded without limit. To attempt unrestricted compensatory action would merely endanger the system with another kind of instability.

Even if a more effective system of controls had already been established, situations might still be encountered from time to time in which the controls proved inadequate. To fall back on an electrical analogy, the economy may be regarded as placing a highly variable demand on the Government powerhouse. At times the capacity of the generators may be exceeded, so that the circuit breakers are tripped. The Government then finds itself in the predicament of being unable to "pick up the load." The only way to avoid futility in endless attempts to reset the circuit breakers is to restrict the demand for power. By cutting off part of the load, limiting it to capacity, power can be rationed and utilized effectively for the best advantage of the system as a whole.

In the major contractions following great postwar booms precisely such a situation develops in the economy. Although it may be unfortunate that the recession cannot then be quickly ended, it is no council of despair to suggest that the Government should observe appropriate limits on the use of its countercyclical powers. The cyclical forces will work in later phases for recovery as well as they do now for recession. In the course of time they would bring about a resumption of growth even without Government action. Since the time would be too long and the depression too deep, the Government

should act. But its action should neither inhibit the natural forces of recovery nor engender a kind of recovery that cannot be sustained.

To use control mechanisms violently will not necessarily result in control but may set up oscillations that are completely destructive of stability. It is not difficult to illustrate this point by setting up models of the multiplier-accelerator type. If compensatory Government action is assumed to fill in for declines in private investment with a lag of two calendar quarters, any kind of cyclical misbehavior can result. Explosive cycles can readily be portrayed by relatively moderate adjustments of the postulated coefficients. If the oscillations should, on even a single occasion, run to the extremes of all-out inflation and deep depression, the misguided attempts at stabilization would tend to discredit valid controls that could in less extraordinary circumstances be made to work effectively.

Study of cyclical models brings out two main points: First, an oscillatory system of this kind can only be stabilized by looking ahead. There is no simple "after the fact" formula—such as filling in for declines in private investment or maintaining consumer purchasing power—that can accomplish this result. It is necessary to anticipate fluctuations in the private sectors and compensate them as they occur.

Second, control cannot be established in a major depression period. In such a period, Government has to use its resources on a rather massive scale just to meet pressing immediate needs, and interim curtailments in the early stages of recovery, like that of 1937, will result in disconcerting setbacks. After all forms of private investment have progressed during the boom beyond the needs of long-term growth, it is too late to hope that activity can be maintained. The resumption of stable growth must then wait until the excesses are liquidated. But if restraint can be applied during prosperity to hold private investment within a reasonable range above the rate required for growth, the actual rate may in the course of time merge into the required rate because the latter will be slowly advancing. Thus, it is in approaching the peak of prosperity that control must eventually be established.

WIDE LATITUDE WITHIN THE LIMITS OF RESOURCES

Another way of looking at this problem is in terms of the size of the Federal deficit. Deficits are implicit, of course, in any of the alternative lines of action that might be undertaken. Moderate deficits may be assumed to have no effects beyond those resulting from the programs in which they originated. This would almost certainly be true of deficits up to \$10 billion a year, and probably also of somewhat higher deficits. Perhaps \$20 billion deficits could be taken in stride for a while if they were expected to be temporary and actual reductions were not too long delayed. But somewhere along the line, the breakaway would be violent.

If it should turn out that deficits of \$50 billion were required to hold the economy at the full employment level, incurring them would not result in stability. It would merely replace one kind of instability with another. The situation would tend to fly off into all-out inflation, with Government credit failing in the flight from money, and then collapse into panic when the inflationary boomlet lost its artificial support.

Barring such extreme developments, the management of the public debt poses no major obstacle to effective action. In one sense, the problem of debt management is no longer significant. It reaches an acute phase in periods of high activity, when conflict between monetary restraints and the desire for low charges on the public debt develops. Now monetary policy must work with Government finance to help ease the depression.

One fortunate factor in the current situation is the adequacy of the monetary system to insure against the kind of financial panic that in times past has resulted in banking insolvency. It is, in fact, difficult to separate in past declines the contributions of real and financial factors to the pressure for liquidation. At the moment only the real factors are involved and the outcome should provide a test of their relative importance in comparison with the financial factors. No amount of financial security, however, could be adequate to provide stabilization of the economy against the other causes of variation. On the monetary front we should be concerned only that financial security be not undermined by efforts to overuse monetary devices in an attempt to remedy economic illness for which they are inappropriate.

In summary, it is suggested that the Government act on various fronts to halt the recession as quickly as possible. In doing so, it should be willing to incur deficits—moderate deficits over a period of a decade, if necessary, and substantial deficits during particular years within that period. There could be no objection to moderate tax cuts, as, for example, by raising exemptions somewhat; but on the whole, tax cutting offers less promise of achieving the desired results than expansion of expenditure programs. The objects of expenditure should be selected in such a way as to use financial resources efficiently and avoid interferences with the recovery of private spending. It should be recognized, however, that by the nature of the situation, recovery may not come quickly despite everything that is undertaken. The shortcomings of the specific measures adopted must not be permitted, in other words, to lead to the abandonment of sound principles of government operation. If extreme fiscal adventures are entered upon in the pursuit of apparent prosperity, the consequence may be failure to achieve stability, ultimate breakdown, and the defeat of efforts to establish effective controls. The Government, though playing a role of substantial magnitude, must be patient with partial results until a point is reached at which control can be established.

NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.,
New York, N. Y., February 19, 1958.

The Honorable HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I have your kind invitation of February 17 to contribute to the investigation by the Senate Finance Committee of the financial condition of the United States.

The economic and financial questions to which your committee is addressing itself are vital to the future of America. The best contribution that I can presently make to your committee's deliberations is contained in a series of lectures that I recently gave at Fordham University on the subject of "Prosperity Without Inflation." I am sending you a copy with this letter in the hope that it may prove suggestive to the committee. You will find specially interesting, I think, the last lecture of my little volume.

With best wishes and personal regards, I am,

Sincerely yours,

ARTHUR F. BURNS.

Enclosure.

CHAPTER FOUR: PUBLIC POLICIES FOR COPING WITH INFLATION

The economic future of America depends largely on what we make of our opportunities. They have never been better than at present. Research and development programs, which only a decade or two ago were conducted on a piecemeal basis, have become a highly systematic and rapidly expanding effort in which private industry, the universities, and the Government are actively joined. This effort is opening up economic opportunities in numberless directions through a constant flow of new products, new materials, and new processes. Our population is increasing at a rate of 3 million per year, or about 3 times as fast as during the 1930's. A progressive shift from low paid and unskilled occupations to better paid and more interesting work is taking place in myriad industries. Inequalities of income such as ruled in earlier periods of our history have been dramatically lessened. Our growing national income is being shared widely and mass markets for consumer products now match our capacity for mass production. The American people are more eager than ever to improve their level of living and are willing to work hard to earn the incomes that may enable them to live as they feel they should. The broad trend of political thought in our country is also favorable to economic growth. Governmental policies are mindful of the need to encourage private enterprise, innovation, and investment, while they remain responsive to the humanitarian impulses of our age. All these domestic factors, as well as the economic revival of Western Europe and other parts of the free world, are improving the long-run prospect of growing markets for the workshops of our economy.

We may, therefore, reasonably expect that our economy will continue to grow rapidly. Setbacks in economic activity will undoubtedly occur from time to time. There will be declines as well as rises also in the price level. But if my analysis in the preceding pages is not too wide of the mark, the broad trend of the consumer price level seems likely to be gradually upward across the decades unless we learn how to manage our economic affairs better than we yet have. As far as the immediate future is concerned, the threat of inflation has definitely abated. But the problems of inflation will return to haunt us. There is no time to be lost in considering, realistically, the ways and means of checking the threat of creeping inflation. For if we continue to tolerate the upward trend of prices, the lives of millions of our people will surely be blighted and the strength of our entire economy may be damaged.

I

As we look to the long future, there are choices before us. Not one path but many may advance us toward the goal of reasonable stability of the consumer price level. We could reduce Government expenditures or restrain their expansion in times of great economic exuberance. We could raise taxes. We could restrain the expansion of credit. We could modify the arrangements under which wages are set. We could alter the price-making process. We could reduce tariffs and abandon or modify other governmental devices for supporting prices. We could work harder and produce more. We could remove or reduce artificial obstacles to higher productivity. And, in principle, we could do any of these things or some combination of them in a great variety of ways.

In practice, our choices are more limited. Some methods of seeking general price stability—such as the allocation of credit or wage and price fixing—are ruled out by our traditions of freedom except under conditions of grave national emergency. Other policies, which would stress the expansion of supply rather than the restraint of demand, may prove very helpful in the long run but quite ineffective in the short run. That is a serious limitation if the advances that occur in the consumer price level during cyclical expansions of economic activity tend to be partly or largely irreversible. Still other methods, such as an increase of taxes, could hardly serve as a useful prescription at a time when the budget is already balanced. Some day in the distant future, it is possible that Americans will be willing to tax themselves at higher rates just to enable the Government to accumulate a sizable surplus and thereby ease inflationary pressures. The time for such a policy has not yet arrived.

Realism requires that we recognize also that governmental policies for restraining inflation—whether they assume a monetary, fiscal, or regulatory character—usually have the quality of austerity. It requires an act of the imagination and some objectivity to understand that, when the economy is already working at or close to its practical capacity, unrestricted credit expansion or liberal Government spending would result in a scramble for resources and a cumulative bidding up of prices. The manufacturer who seeks to expand his activities will not always accept with quiet understanding the need to put up with a smaller loan than he requested from his bank. Nor will the homebuilder or merchant or consumer. When a policy

of credit restraint is being pursued by the monetary authorities, many firms or individuals who feel that their opportunities are being restricted will naturally blame the Government for their failure to accomplish all that they had planned. And so it will be also if the Government reduces its expenditures, since there is no way of doing this without reducing the sales of some businesses or forcing some men and women to look for new jobs.

Clearly, governmental policies for checking inflation cannot be expected to be as popular as policies for reducing unemployment. However, popular enthusiasm for a policy is also not a prerequisite for its adoption. It is sufficient if the policy can gain broad support and if it is viewed as an economic or moral necessity. Public sentiment has been moving in the direction of acceptance of anti-inflationary programs at a time of general exuberance. It is likely to continue to do so, provided people retain confidence in the Nation's ability to prevent serious economic slumps. The broad masses of wage earners, as they look to the future of their families, have most to gain from stopping the creeping advance of the price level and increasing numbers among them know this. But they are not likely to support the austere policies that are required to contain inflation at one time, if they fear for the security of their jobs or for their opportunities of advancement at a later time. Nor will many businessmen support anti-inflationary policies in such circumstances.

It would be a grave mistake to assume that the increasing concern of people over the upward climb of the price level justifies or requires half measures in dealing with the problem of recession. Very many of those who today are worried about the cost of living will be worried still more about their jobs if unemployment should spread. If, therefore, we wish to create a climate of opinion that will support effective policies at times when the stability of the dollar is threatened, we can ill afford anything that at any time revives fear of a business depression. This means, as we look to the long future, that, whenever the economy shows signs of faltering, the Government must honor by its actions the broad principles of combating recession which served us so well during the decline of 1953-54. It means, since no two recessions are alike, that the scale of governmental measures, their precise sequence, and the manner of their coordination must be skillfully adapted to the peculiarities of the individual case. And it also means that it would be wise not to lose time in extending recent efforts to strengthen the resistance of our economy to such recessionary tendencies as may develop from time to time.

Several steps in this direction can be usefully taken. One is to amend the Highway Act of 1956 so as to permit some flexibility of this tremendous program in the light of economic conditions. Another is to extend the carryback of business losses for tax purposes beyond 2 years, which is the limit under present law. A third is to extend the principle of deposit insurance to the share accounts of credit unions, which are growing very rapidly although they are still small in relation to deposits in commercial or savings banks. A fourth, and perhaps the most constructive immediate step, would be to improve our unemployment-insurance programs. Unemployment insurance is the Nation's first line of defense against depression. When business activity falls off, the payment of insurance benefits promptly

risers and, thus, offsets in part the decline of incomes from productive employment. Although unemployment insurance cannot, of itself, prevent a decline of aggregate economic activity, it can significantly check the rate of decline and thereby make it easier for both private and public policies to be adjusted in a calm atmosphere. Despite the substantial reforms that have been made in our unemployment-insurance system during the past 3 or 4 years, there is considerable room for further improvement. About 12 million of the Nation's wage earners are as yet entirely unprotected, and in numerous States both weekly benefits and their maximum duration still fall short of the level that the President has repeatedly recommended.

As we move to strengthen the Nation's defenses against depression, we should also move—and we could then do so with an enhanced basis for hope of achieving permanent results—to strengthen our defenses against the threat of creeping inflation. What we need more than anything else at this juncture of our great experiment in the management of prosperity is a national declaration of purpose with regard to the level of prices that could have a moral force such as the Employment Act already exercises with regard to our levels of production and employment. This can be simply accomplished by including reasonable stability of the consumer price level among the objectives of the Employment Act which “it is the continuing policy and responsibility of the Federal Government to use all practicable means” to promote. It has been said that such an amendment of the act is unnecessary, since it already covers the objective of general price stability by implication. I would agree to this interpretation of the law. Nevertheless, I believe that it would be a highly constructive step if the Congress stated explicitly what the act appears to some of its interpreters to state implicitly. One of the main factors in the inflation that we have had since the end of World War II is that many consumers, businessmen, and trade-union leaders expected prices to rise and, therefore, acted in ways that helped to bring about this result. A declaration by the Congress that it is the continuing policy of the Federal Government to promote reasonable stability of the consumer price level, as well as “maximum employment, production, and purchasing power,” could go a considerable distance in dissipating the widespread belief that we are living in an age of inflation and that our Government, despite official assertions and even actions to the contrary, is likely to pursue an inflationary course over the long run.

It is sometimes argued that a mere declaration of purpose concerning the stability of the dollar would be futile in the absence of some specification of how this objective is to be realized. That is a possible result, but I am inclined toward greater optimism. The language of the Employment Act, as it stands, is extremely general. The act does not specify how the Government should “promote maximum employment, production, and purchasing power,” beyond observing that it is to proceed “in a manner calculated to foster * * * free competitive enterprise and the general welfare.” Yet the general language of the act has not led to inaction or frustration. On the contrary, it has in practice proved a source of strength, for it has allowed Government officials the utmost freedom in devising means to fit particular and unforeseeable circumstances. The force of the act derives entirely from its affirmation of basic policy, and this would continue to be true if the act were amended.

Broadening of the act, so as to include reasonable price stability among its objectives, would tend to make it a constant reference point for public and private actions that bear on the level of prices. One of the likely consequences of the suggested amendment would be a greater emphasis in the President's annual economic report on the outlook for prices and on how reasonable stability of the price level is to be sought. The reports of the Joint Economic Committee of the Congress would naturally move in a similar direction. Policies that promote stability of the price level would, therefore, tend to gain in prestige and to exercise increasing power over the thoughts and actions of both Government officials and private citizens.

I recognize, of course, that movements of the consumer price level and of the physical volume of economic activity may diverge for a time and that Government officials may occasionally be uncertain whether to give greater heed to the one or to the other. It is easy to exaggerate the trouble that this difficulty, which inheres in the economic process, will cause in practice. What Government officials do now is to shape economic policy in the light of emerging trends in production, employment, and prices, as well as the many factors that impinge on the movements of these magnitudes. They recognize the tendency of consumer prices to lag behind wholesale prices and industrial activity and they allow as they best can for this lag. They recognize that full employment in a practical sense is a zone rather than a point or line, and that the same must apply to a stable price level. They pursue policies that will help to maintain the employed percentage of the labor force as well as the consumer price level within a neighborhood that allows for minor movements in the one and the other. They do not seek perfection in terms of any single yardstick, but a good all-round performance. The suggested amendment of the Employment Act would change these attitudes and procedures only to the extent of leading to somewhat greater vigilance with respect to price developments.

If this proposed amendment had been in effect 5 years ago, I am morally certain that the measures that were taken to check the recession of 1953-54 would have been no less prompt or extensive. On the other hand, I believe that stronger anti-inflationary policies would have been adopted in 1955—which was the critical time to check the newly gathered forces of inflation. It is because I expect that the proposed amendment would strengthen efforts to deal with inflation, while it would in no way reduce zeal in checking recessions, that I regard the explicit inclusion of reasonable stability of the consumer price level among the objectives of the Employment Act as a wise and progressive step at this time.

II

The precise governmental policies that will need to be applied in later periods of vigorous expansion cannot be usefully delineated in advance. It seems clear, however, that fiscal policies will need to occupy a more prominent place in an anti-inflationary program than they have received of late. The forces that make for high governmental expenditures are and will remain powerful. There is little likelihood that the sums needed for our national defense will soon diminish. On the contrary, we may well be spending appreciably more in coming

years on our defense programs and on the research work that vitalizes them than the huge sums now being spent. There will also be insistent demands for larger expenditure on various public facilities, such as highways, schools, and hospitals, which are needed to support the growth of the private economy. Expenditures on education, medical research, slum clearance, social-security benefits, and other welfare programs are more likely to increase than to diminish during the next decade. It is precisely because governmental operations will continue to be a very powerful force in our economic life that we will need to attend closely to the danger that they may, at least at times, lead to an overstimulation of the economy.

A balanced budget is often regarded as indicative that the fiscal operations of the Federal Government are neutral in their economic effects, in the sense that they have neither an expansive nor a contractive influence on the level of the Nation's total output or expenditure. This simple view, however, overlooks the fact that the impact of a huge sum of tax money spent by the Government may be very different from the impact of an equivalent expenditure by consumers and business firms. In the first place, Government officials as a group are probably somewhat less efficient shoppers than private citizens. Second, the prices of much of what the Government buys are reckoned on a cost-plus basis or something close to it. Third, Government contracts are ordinarily subject to special provisions regarding wages and other labor standards. Fourth, the high income taxes that are imposed to finance high Government expenditures occasionally lead businessmen to be improvident about the prices or wages that they pay. Fifth, expenditures by the Government, which nowadays are of necessity heavily concentrated on national defense, seem unlikely to contribute to the improvement of industrial capacity and productivity to the same degree as would private expenditures of the same magnitude. Sixth, when an increase in governmental expenditures is financed by an increase in taxes, the increase in public spending will not always be accompanied in the short run by an equivalent reduction in private spending, so that the Nation's total spending may well be larger as a result of the expansion of a balanced budget.

These considerations at least suggest that huge governmental spending, even when it is fully met from tax revenues, is likely to release inflationary forces in the economy. But it is not necessary to settle this theoretical issue to arrive at a sound judgment concerning economic policy. Whether a balanced budget is deemed inflationary or not, the mere fact that the budget is balanced at a time when the economy is operating close to its practical capacity hardly justifies complacency about fiscal policy. Monetary and credit controls are undoubtedly helpful in checking private expenditures, but experience suggests that they are not likely to prove helpful enough. Official appeals for restraint in wage and price adjustments may be salutary, but experience suggests that it would be unwise under ordinary circumstances to expect a broad response to exhortation. Hence, apart from periods of national crisis, which may require increases in defense expenditures that are far beyond any reductions that can be effected in other programs, the Government must lead the economic community in the practice of restraint. In other words, if the economy is operating close to its full capacity and the budget is already balanced, the Government must discipline the natural impulse to use

the larger revenues yielded by existing tax rates to finance new expenditures. In such circumstances it is desirable to strive for a sizable surplus by severely limiting any increases in expenditures and, wherever possible, reducing them. Not only that, but if a surplus already exists, the objective under the assumed circumstances should be to increase it.

Political factors will not make it easy to carry out such a policy. Recent history indicates, however, that a resolute stand by leaders of the administration and the Congress can stave off demands for tax reductions. The pressure for increased governmental spending may present greater difficulties. Neither Government officials, nor our political parties, can be insensitive to the possible opportunities for advancing the general welfare by increasing public expenditures on school buildings, scholarships, medical research, scientific laboratories, economic statistics, public employment offices, technical services to business or agriculture, slum clearance, highways, or public parks. It is undoubtedly true that higher expenditures on these and countless other items will often bring benefits to the American people that would fully justify their cost. Yet a government that sought to do at once everything that is or that seems desirable would invite economic and financial disaster. There are limits to what the Government can accomplish. The limits are set in the first instance by its financial resources, and they are imposed in a more fundamental sense by the Nation's real resources. If the Nation is already enjoying full employment or something close to it, any appreciable increase of spending—whether by private citizens or the Government—will mainly serve to mark up prices. Under such conditions the administration should be able to insist with a reasonable expectation of popular support that, while many of the programs that are being urgently advanced have great merit and should eventually be undertaken, it would serve the Nation's best interests to postpone them to a time when the demands placed on the resources of the economy have diminished.

Suppose that the President, before turning to specific recommendations for the coming year in his budget message and the economic report, took a long view and outlined in general terms the needs of the Nation and the various governmental programs that should either be started or expanded over the next few years. If the economy is already operating at or close to full capacity, he could then argue for great restraint in public expenditures during the coming year, without subjecting his administration and political party to criticism on the ground of being complacent or of being unmindful of the need for social betterment. A move in this direction in the formulation of governmental plans may in the course of time prove immensely helpful in limiting the political pressures which tend to drive us, year in and year out, toward larger governmental expenditures.

What I am urging is a concept of flexibility in public expenditures which is much broader than the traditional concept of dovetailing public works with variations in private economic activity. Years of very hard work will unquestionably be needed to translate this concept into a workable tool of government. A long-range view in the President's economic and financial messages to the Congress will not

of itself suffice. Many other measures and reforms will be necessary. In view of the constant pressure to add new governmental programs, better machinery than now exists will need to be devised for review and reappraisal of existing programs. The planning of public works, which has been pushed vigorously in recent years to serve the Nation at a time of possible depression, will need to be enlarged to deal with the stretching out of going projects at a time of inflationary pressure. All new programs will need to be brought together in the budget message, so that their cost—not only in the coming year but in each of several succeeding years—may be readily grasped. Most important of all, the accounting and budgeting techniques of the Government will need to be reformed so that they may better serve the purpose of controlling expenditures. At the present time, governmental expenditures can go a very considerable distance either above or below the sums that are budgeted because the accounting methods, particularly of the Department of Defense, make close managerial control impossible.

III

Although it will be necessary to lean heavily on fiscal policy in our quest for reasonable stability of the consumer price level in the future, it would be unwise to neglect monetary policy. The importance of checking the growth of credit at a time of advancing prosperity, whether or not excesses spill over into consumer markets, must never be minimized. With all its limitations, monetary policy can also make—and in fact recently has made—a useful contribution to curbing the advance of consumer prices. This contribution can be greater in the future if we learn how to deal with the obstacles presented to an effective monetary policy by our economic and political environment.

It would be unrealistic to hope that credit restraints will be greeted with great popular enthusiasm in any future that need concern us. However, something can surely be done to improve the political climate for carrying out such a policy when economic conditions require it. As we have noticed, there appears to be some basis in experience for the criticism that at a time of general credit restraint the economic opportunities of smaller businesses are restricted more severely than the opportunities of large firms. To the extent that this problem exists, we should deal with it by opening a safety door for small businesses, not by abandoning or weakening general credit controls. One way of proceeding would be to enlarge the operations of the Small Business Administration when general credit restraints are being exercised. Such a solution may be very useful as a stopgap, but as a permanent policy it is objectionable for two reasons. In the first place, it is doubtful whether the public interest will be well served by having the Government get deeper into the banking business. Second, the activities of the Small Business Administration could grow large and be pursued in a manner which seriously interfered with the policies of the Federal Reserve System. I believe that a more constructive way of attending to the difficulties of the small business community at a time of generally tight credit would be to draw on the powers and facilities of the Federal Reserve System itself.

Thus, when the Federal Reserve authorities embark on a policy of credit restraint, they might simultaneously take steps to prevent undue restraint of small business enterprises. They could do this under existing law in at least two ways. First, they could favor at the discount window those banks which were attending with special solicitude to the requirements of their smaller customers. Second, they could breathe life into section 13b of the Federal Reserve Act, which has been allowed to become virtually dormant in recent years. Under this section of the law, the Federal Reserve banks have the power to extend credit directly to a sound business that is unable to meet its needs through regular commercial channels. The law limits loans to established businesses, to the provision of working capital, and to a period not exceeding 5 years. It would be desirable to lift these restrictions by an amendment. But even under existing law, much could be done at a time of credit stringency to relieve the financial difficulties of small businesses. In view of their intimate contacts with local financial institutions, the Federal Reserve banks should be able to refer many of the loan applicants to commercial banks or to development corporations that could accommodate them in whole or in part. It seems unlikely that the Federal Reserve banks would need to assume very many of the loans themselves. To the extent that they did, they could intensify somewhat their general controls so as to approximate the overall restriction that they took as their practical goal. In this manner the Federal Reserve authorities would be attending constructively to the special problems of the small business community and at the same time helping to create a political environment that would be more salutary for their operations.

The financial handicaps of the home-building industry at a time of credit shortage require a different attack. Here the difficulty stems largely from the unrealistic maxima that are imposed by law or regulation on the interest rates of governmentally underwritten mortgages. There is no way of getting private capital to flow abundantly into such mortgages when it can earn more in other investments. Efforts by the Congress to protect the ceilings on interest rates by regulating discounts only aggravate the problem. Unhappily, there are political obstacles to a solution that fully respects market forces, and governmental adjustments of interest rates are apt to come much too slowly. However, experience even in this area indicates that progress is not impossible. What we need to do is to practice greater foresight and to make a determined effort at reform of our housing laws, so that artificial interest rates cease working as a selective control to the disadvantage of the home-building industry when credit conditions are tight. Unless such a reform is carried out, there is always a danger that general credit controls may be weakened by the political unrest that distraught home builders can stir up when they find their markets slipping while other industries are booming.

The political environment for flexible monetary policies might also be improved by removing or lifting statutory ceilings on the interest rates that can be paid by some of our local governments. It would surely be desirable to develop ways of broadening the market for the securities of local governments, particularly of the

smaller municipalities and school districts, so that they may have better opportunities to borrow at reasonable interest rates. Some experimentation along these lines has been under way and needs encouragement. One contribution that the Federal Government might make is to revise the tax laws so as to permit investment companies to pass on to their stockholders the tax-exempt status of the income derived from local securities.

Another and more important problem that requires attention in the interest of improving the political and administrative basis of Federal Reserve policy is the large short-term debt of the Federal Government. The Treasury's need to refinance substantial blocks of securities every few weeks or months unavoidably hampers the Federal Reserve authorities in pursuing a firm and consistent policy. This difficulty will remain serious until a substantial part of the Treasury's short-term debt is funded. Whatever may be said in favor of a cyclically flexible policy of debt management, it has not worked out well in practice. If it has proved difficult to carry out funding operations in a period of economic boom such as we have recently experienced, it is practically sure to seem still harder to do this when the Nation's business turns sluggish. Since the ideal time for funding, from a business cycle standpoint, is likely to elude us in the future as it has in the past, it may be best to revise our methods of managing the public debt and to try out a policy of putting out small blocks of medium- or long-term issues at fairly regular and frequent intervals.

If systematic efforts to soften the uneven impact of general credit controls and to lengthen the outstanding maturities of our public debt are attended by success, the Federal Reserve authorities will gain a greater sense of freedom in conducting the Nation's monetary policies. There is a serious question, however, whether the economic power of the Federal Reserve System—that is, its ability to restrain the expansion of credit with reasonable promptness and yet without shock—may not have been eroded in some degree by the narrowing of the economic base on which its policies impinge. Our financial system has become far more complex than it was at the time Federal Reserve Act was framed or during the 1920's. Commercial banks, which once dominated the entire financial system, have shrunk in importance. We have today not one banking system but several, each subject to different regulations, different taxes, and different modes of supervision. By controlling the reserves of commercial banks, the Federal Reserve System can still exercise close control over the growth of bank assets and of the money supply. But the Federal Reserve authorities have little influence, at least in the short run, over the volume of credit extended by other financial intermediaries or over the creation of money substitutes. Indeed, there is reason to believe that these activities may for a time be stimulated by a policy of general credit restraint.

Various ways have been suggested of reconstructing our financial machinery so as to enhance the effectiveness of monetary policy. One suggestion is to require various financial intermediaries to hold reserves against their liabilities on a basis similar to the requirements imposed on commercial banks. Another suggestion is to free commercial banks from some of the regulations that may have impeded their growth—in particular, to restore their power to pay interest, if they

so choose, on demand deposits. A third suggestion is to give the President or the Federal Reserve Board standby authority to regulate the terms of consumer installment credit and perhaps also the terms of conventional housing mortgages. It is interesting to speculate about these and other possibilities; but it would clearly be undesirable to tinker with the delicate machinery of finance, on which the workings of the entire economy so largely depend, until a comprehensive study of our financial system and of the basis of monetary policy has been carried out by men of wide knowledge and experience. With all of its shortcomings, the financial system that we have evolved is wonderfully efficient, and it would be unwise to change it in any important respect until the implications of the proposed change have been thoroughly studied and are well understood. Since the Congress has taken a negative attitude toward the proposal for a National Monetary and Financial Commission, it is fortunate that a citizens' commission is now being privately organized to assume responsibility for a thorough and objective reexamination of our financial system and of our tools of monetary policy.

IV

It is hardly necessary to argue further that our monetary and fiscal policies both should and can become a more effective weapon against inflationary pressures than they have been in the recent past. Just as we have done better in combating inflation in the last few years than in the early postwar period, so it seems reasonable to expect that effort, persistence, and imagination will bring more striking success in the future. There is room for doubt, however, whether the threat of creeping inflation can be adequately met within the framework of business-cycle policy alone. The smaller the burden that is imposed by our complex of laws and the course of events on flexible monetary and fiscal policies, the better are the chances that they will approximate what we expect of them. That is why I have put so much stress on the need for a declaration by the Congress that it is the continuing policy of the Federal Government to promote reasonable stability of the consumer price level, as well as maximum employment, production, and incomes. Such a declaration of policy may be expected to have an influence that is incomparably greater than exhortation by high officials, for it would put private groups as well as public officials on notice that the Government is determined to find a way to reasonable stability of the price level.

We must not blink the fact that big corporations and big trade unions have made a difference in the workings of our price system. The rivalries of the business world are nowadays as keen or keener than ever. Competition with respect to quality of products and the services associated with them has increased. However, less stress is being placed by many of our larger businesses on price competition. Meanwhile, the growth of nationwide trade unions has introduced elements of monopoly in many of our labor markets. It has also fostered active rivalry among trade union leaders in pressing for higher wages and more liberal fringe benefits, often with little regard to what is happening to the Nation's overall industrial productivity. Employers, on their part, have often been willing to concede what is demanded by trade unions, partly because of a feeling of helplessness, partly because

of the comforting thought that their competitors would have to foot the same bill, and partly because they have reckoned that any increase in labor costs per unit of output could be passed on to their customers. These practices of trade unions and business managements are not likely to be changed quickly. We must, however, keep in mind that the threat of creeping inflation is a long-range problem, and that the best solution—all factors considered—is likely to be one which evolves with a minimum of social and economic disturbance.

Although I believe that inclusion of reasonable stability of the price level among the objectives of the Employment Act would help to reshape the wage policies of our trade unions and both the wage and price policies of business firms, it would be desirable for the Government to go further at this time. Business monopoly is prohibited by law, and the enforcement of our antitrust laws has of late been very vigorous. Trade unions, however, enjoy immunities under the law that are denied other groups or individuals. Our antitrust laws need strengthening in their application to the business world, as the President and many leaders in the Congress have repeatedly pointed out. The least that we can do with regard to trade unions is to subject their finances, as well as the election of their officials, to standards defined by law. Such legislation would of itself have no effect on what happens at the bargaining table; but it should help to remind the leaders of our trade unions that unless they practice greater restraint and foresight, the Government may need to take drastic steps to curb their power to push up costs and prices.

It is not too much to hope that the suggested amendment of the Employment Act, besides stimulating private groups to reexamine their policies, would foster a reappraisal of the effects of many of our public policies on industrial productivity and competition. Our tariffs, import quotas, agricultural price supports, stockpiles, and multiform subsidies—all require a new look. So, too, do our policies with regard to education, research, taxes, patents, and depreciation, on which the Nation's productivity so largely depends in the long run. And so do the featherbedding practices that are sanctioned by labor agreements to the detriment of costs and productivity. Needless to say, reasonable stability of the consumer price level can never be more than one objective of governmental policy among others. Nothing can compare in importance with a strong national defense. A high and expanding level of employment, a prosperous agriculture, conservation of natural resources, the vitality of small businesses, expanding homeownership, and decent neighborhoods for our children—these also are central objectives of national policy. The pursuit of these and other objectives that Americans hold dear is bound at times to release forces that tend to drive prices higher. But once we make reasonable stability of the price level one of the key objectives of the Nation's economic policy, and do this so plainly that there can be no mistaking the fact, it seems likely that public officials will become more enterprising in seeking ways and means of offsetting or containing the price-raising forces that some governmental policies—whether with regard to agriculture, foreign trade, trade unions, or other areas of national interest—unavoidably release.

V

There are several reasons why a broad approach to the problem of inflation, such as I have tried to suggest, carries a greater promise of success than concentration on any particular tool of policy. One is that none of our tools is as yet sufficiently dependable by itself. Another is that there are always limits to the extent to which any specific policy, whether it be credit restraint or anything else, can be wisely pushed in practice. Furthermore, unless the goal of stabilizing the price level is simultaneously pursued by our leading governmental agencies, there is always the danger that one agency or another will be left to carry the burden of resisting inflation while the rest take an independent course, with the probable result that any inflation that may be underway is intensified.

The basis for effective planning and coordination of the economic policies of the Federal Government was laid by the Employment Act, which established a Council of Economic Advisers within the Executive Office of the President. Two major defects that soon became evident in the Council's operations were corrected in 1953. The first stemmed from the fact that under the law the three Council members not only had identical intellectual responsibilities which is as it should be, but also had identical administrative powers, which can lead to confusion. This difficulty was eliminated by a reorganization plan which delegated to the Chairman of the Council the responsibility for administering its affairs and for reporting to the President on its work. At the time of this reorganization, the President also established an Advisory Board on Economic Growth and Stability under the chairmanship of the Chairman of the Council. This Board was designed to overcome another difficulty in the Council's operations—namely, the want of regular governmental machinery whereby the economic thinking and planning of the Council could be brought continuously to bear on the work of the executive departments and agencies or whereby their economic plans could be brought continuously to bear on the work of the Council. To advance further an informed and systematic approach to governmental economic policies, the President later assigned a large role to the Council in Cabinet discussions of economic matters.

As a result of these devices, and other procedures that have developed from them, very considerable strides have been taken toward the improvement of economic policymaking within the Government. Both the means and the experience now exist for another major advance in the machinery of formulating and integrating the economic policies of our farflung government. This can be simply and effectively accomplished by lengthening the arm of the Advisory Board on Economic Growth and Stability. The Board now meets weekly. It includes representatives, usually at the Under Secretary level, of 6 Departments (State, Treasury, Commerce, Labor, Agriculture, and Health, Education, and Welfare) and 4 agencies (Federal Reserve Board, Bureau of the Budget, Council of Economic Advisers, and the White House Office). The Board might continue to function as it now does, except that its deliberations would be preparatory to periodic—say, monthly or semimonthly—meetings at the highest level of our Government. These climatic meetings of the Board

would be conducted with the President in the chair and with the heads of the departments and agencies represented on the Board, as well as their deputies, in full attendance. Through this simple transformation of a device of government that has already been tested and found useful, a consultative body would come into existence which would carry a weight in decisions on basic economic policies that would be fully comparable to that of the National Security Council in its sphere. Any such change in the status of the Advisory Board lies entirely within the President's discretion. I need only add that if the President saw fit to elevate the role of this Board, none of the responsibilities of the participating officials or agencies under existing law would require modification.

The Secretary of the Treasury has recently announced that informal meetings are to be held from time to time with the President, which will bring together the Chairman of the Federal Reserve Board, the Chairman of the Council of Economic Advisers, the special assistant to the President concerned with economic matters, and the Secretary of the Treasury. I hope that this development, which rightly recognizes the importance of the Federal Reserve System in the economic scheme of government, will soon lead to the larger and more formal Board that I think is required to cope with our major and changing economic problems. The Nation needs greater assurance than it now has that our Government is equipped to deal on a consistent basis with the threat of inflation. It likewise needs assurance that the Government or one of its central organs will not become so engrossed in the long-run problem of creeping inflation that any immediate problem of recession is neglected. Needless to say, the reconstruction of the Board of Economic Growth and Stability, along the lines that I have sketched, will not of itself prevent mistakes in economic policymaking. It will, however, provide a maximum of opportunity for balanced judgment and it will facilitate the early correction of governmental policies that are found wanting.

Reasonably full employment and a reasonably stable price level are not incompatible. We have often come close to this ideal in the past, and we have done so again recently during the years from 1952 to 1955. The matters that I have stressed in these pages—explicit recognition of reasonable price stability among the objectives of the Employment Act, improvement in the practical workings of monetary and fiscal policies, the reduction of monopolistic practices, and better organization of economic policymaking—will not be attained without great and continuing effort. But if I am right in thinking that these measures will significantly improve our chances of maintaining a reasonably stable consumer price level as well as reasonably full employment over a long span of years, the effort is surely worth making.

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NATIONAL PLANNING ASSOCIATION,
Washington, D. C., April 18, 1968.

Hon. HARRY F. BYRD,
*Chairman, Committee on Finance,
United States Senate, Washington, D. C.*

DEAR SENATOR BYRD: You asked me on February 17th to answer a number of questions by April 1. This deadline was extended by members of your staff and I am submitting to you my answers today. I have answered most, but not all, of the questions and combined in a few cases my answer to several questions. I hope that you find this material of some value for your purposes.

Cordially yours,

GERHARD COLM.

Enclosure.

ANSWERS TO QUESTIONS OF SENATE COMMITTEE ON FINANCE BY DR.
GERHARD COLM¹

1. DEFINITION OF DEFLATION AND INFLATION

I propose to call deflation and inflation conditions of economic disequilibrium in which there is a general contraction or expansion of purchasing power. The contraction or expansion may originate in one sector but thereafter spread to other sectors of the economy. This implies a change in the supply of money and/or a change in the velocity of circulation of money.

DEFLATION AND INFLATION NOT MERELY CHANGES IN PRICE LEVEL

Deflation and inflation are most commonly defined as decreases or increases in the general price level. Indeed deflation and inflation as defined above are usually but not always associated with price declines and price increases. The price changes per se, however, are not the essence of the phenomena which I would call deflation and inflation. Price declines and price rises may take place for reasons which have no relationship to deflation or inflation; and there can be deflation and inflation without price changes. During the boom period 1926-29, for example, consumer prices were falling whereas during the current recession prices have been rising in spite of the economic slack. Then, too, we have "suppressed" inflation when Government price controls prevent a price rise in spite of the creation of excess purchasing power (e. g. during World War II). We can also have deflation as defined above when business price policy prevents or slows down price declines in spite of a contraction in purchasing power.

¹ Chief economist, National Planning Association.

The views expressed are those of the author and not necessarily those of the National Planning Association. Manuel Helzner has assisted me in the preparation of the answers.

Price changes which in the meaning of the proposed economic definition would not be inflation or deflation may be illustrated by the following examples:

Assume a country had an excellent harvest; food supply increases and food prices drop. The drop in food prices stimulates consumption so that the market is cleared of the large harvest. Farmers sell and consumers buy a larger quantity at lower prices. In this case, the initial disequilibrium between supply and demand resulted from a physical event rather than from a monetary change. The drop in food prices helped to restore the equilibrium between supply and demand. Even if the drop in food prices should cause a drop in the general price level, I would not regard this situation as a case of deflation.

The reverse would be true in case of a poor harvest and a consequent price rise. If the price rise results directly in a curtailment of consumption again no monetary injection of purchasing power is required and the price rise serves as an equilibrating force. Farmers would sell and consumers buy a lower quantity at higher prices. What we observe is a remedial and not a pathological process.

Assume, however, that in the last example the price rise does not result directly in a curtailment of consumption but that many income receivers succeed in increasing their incomes. Then prices will rise still further until the consumption of those income does not keep up with rising prices is curtailed sufficiently to equate supply and demand at the higher price. This price spiral, however, would require an injection of money or increased velocity of circulation of money to finance transactions on a higher price and cost level. The inflation process in this instance is pathological because the initial price rise does not directly fulfill the remedial functions of equilibrating supply and demand. (See also answer to question 16.)

In the modern economy severe demand inflation has been typically the result of war finance. However, milder forms of demand inflation can also be caused by large increases in investments or consumer spending. Conversely, deflation is typically caused by contracting Government finance or a contraction in private credit-financed purchases. If, for example, in case of a curtailment in Government activities (e. g. curtailment in armament expenditures) the price of labor or steel, etc., would drop and stimulate the use of labor and steel in private use, the price drop again would simply play an equilibrating role. If, however, these prices fail to drop or if the price drop fails to stimulate a compensating increase in the private use of these materials, the drop in Government activities would result in unemployment and curtailment in production; private incomes and private spending would fall. Instead of a compensatory increase in private activities we experience then a cumulative destruction of purchasing power—a process, which we call demand deflation.

It is an important fact that in the modern economy the price elasticity of demand for basic factors of production is relatively low. Demand for many basic industrial commodities does not respond readily or significantly to moderate changes in price (within the limits of substitution). For this reason fluctuations often occur in employment and production rather than in prices in response to changes in demand.

To summarize, deflation and inflation are processes which involve either the excessive destruction or excessive² creation of purchasing power. They are processes which result from the failure to restore equilibrium through the direct working of the price mechanism. Therefore, they are pathological processes. As deflation and inflation are not just decreases or increases in the price level, it is not paradoxical if it is observed that at times we have had inflation without price rise and deflation without price declines or even with creeping price rises.

DEMAND INFLATION AND COST INFLATION

With respect to inflation a distinction has recently been made between a demand-pull inflation and a cost-push inflation. Although this distinction has often been presented in considerable oversimplification, there is a good deal of validity in it and it has important consequences for policy measures.

Inflation always involves cumulative processes which require the injection of additional purchasing power (additional money created by credit or an increase in the velocity of circulation). The inflationary process however may originate either through excessive demands being generated by government, business, or consumers, or through increases in the price of materials or labor. Both types of inflation are typically intertwined. If inflation is sparked by excessive demand, increases in the prices of labor and material will rise and lift the whole income and cost structure of the economy. If the primary increase should take place in the prices of labor and material, the injection of additional credit would be needed to make transactions at the higher cost level possible.

The term "cost push" inflation has often been interpreted as suggesting that price rises typically originate in excessive wage increases (that is, in excess of productivity gains). This is, however, not the only possibility. It may be that some business firms are able to charge higher prices in spite of slack demand and that wage increases merely keep up with the price rise. Gardiner Means speaks of this situation as "administered" inflation—that is inflation resulting from "administered" price or wage determination. I fear, however, that some people will think that an "administered" inflation is an inflation brought about by action of the Government administration, which would be a complete misunderstanding. Also the term "excess capacity" inflation has been proposed in order to indicate that this kind of inflation may occur even when there is no excess demand. The disadvantage of this term is that we may have the same causal factors at work even when there is no excess capacity in which case both types of inflation processes—cost and demand pressures—may be operative at the same time.

The relationship between demand and cost inflation may extend over a period of time. Assume a demand inflation results in high prices in period "t1." Assume further that in period "t2" excess demand has disappeared. However, in some industries increases in wage rates to compensate for the price rise will take place only in this period "t2." This increase in wage rates in some industries starts a wave of wage-rate increases not directly related to demand inflation. Thus, the aftermath of demand inflation may become the begin-

² "Excessive" is meant in relation to the potential production.

ning of a cost inflation. The "inflation" of the year 1957 may show some similarity with the "t₂" period of our example. This example demonstrates that it is not meaningful to ask whether wage increases or price rises are responsible for inflation. They are interlocked.

People trained in classical economic theory may deny that a cost or excess capacity inflation is possible. For them it is difficult to understand why prices should be raised except in response to an increase in demand. Even a monopolist who presumably always charges what "the traffic will bear" cannot expect to gain by a price rise except when consumers are willing to pay more for the same quantity of products. The theory of "administered" prices is based on the belief that the producers for a variety of reasons normally do not charge the very maximum price which the traffic will bear. Therefore, they have a margin for price rise which they can use at a time which appears opportune to them. A producer may have been satisfied with a price well below the "peril point" of substitution as long as profits made possible a satisfactory level of dividend distribution and adequate internal accrual of funds for replacement, modernization, and expansion of plant and equipment. If, however, gross profits become unsatisfactory because of a rise in costs (e. g., wage rates) or a contraction of sales, the producer may be inclined to push his prices more nearly to the limit of what the traffic will bear. A rise in wage rates and prices in industries in such a situation may be advantageous from the aspect of that particular group of producers, but it may be undesirable from the aspect of the economy as a whole. This may help explain why prices do not drop so readily in a period of recession.

DEMAND AND COST DEFLATION

Is there a condition of cost deflation corresponding to the condition of cost inflation which we have discussed above? We could imagine, for example, a situation in which demand is adequate or even excessive but in which because of technological advances there is some unemployment and a downward pressure on wage rates. If the reduction in wage rates merely stimulates a more labor intensive type of production it would be of the remedial nature which we would not call deflation. More likely, the wage reduction may become general thereby resulting in more and quicker curtailment of mass purchasing power than is added to mass purchasing power by the hiring stimulated through the wage reduction. In this case a general deflation may ensue, originating by reduction in the price of one cost factor, namely, labor.

2. POLICIES TO AVOID INFLATION AND DEFLATION

A. Policies to avoid inflation

(a) *Demand inflation.*—In case of demand inflation there are logically two remedies, namely, either to step up supplies or to curtail demand. Obviously the positive measure of promoting an increase in production has advantages over the restrictive policies of curbing demand. An economy usually has some production reserves which can be mobilized. However, such measures as working overtime, offering full time or part-time jobs to the retired (e. g., by modification of provisions in the social-security laws), facilitating work of

women and similar measures not only add to total production but also add to incomes and consumer demand. Thus only a fraction of the increase in total production can actually be regarded as an anti-inflationary measure. Also a lowering of import duties would increase the supply of goods and would serve as an antiinflationary measure.

In appraising the contribution which increasing supply can make to remedy a situation of excessive demand, it is important not only to evaluate the conditions of supply and demand as they exist at the moment but to protect them over the period of time during which countermeasures could become effective. One should not forget in such appraisals that we are living in an economy in which potential production is increasing year after year by 3 to 4 percent or about \$15 billion. Of course, the other side of the coin should not be forgotten either; namely, that, if production increases by these amounts, the income and demand of the producers will also rise.

In case of excessive demand it will first have to be examined what kind of demand has been increased and may be regarded as the cause of inflation. If it is, for example, a demand for greater national security, it may be assumed that the increase is taking place for compelling reasons of foreign policy. Then increases in other demand categories (e. g., other Government programs, business investment, consumer demand) may have to be limited or resource utilization may have to be expanded. If the increase in demand is of a nature of lesser national urgency (e. g., speculative demand for consumers or business as in the period of scare buying in the second half of 1950), then it would be most desirable to curb that particular kind of demand by countermeasures.

Policies available for curtailing demand include credit policy, tax policy, sometimes persuasion, and, in extreme situations, direct controls.

The anti-inflationary policies to be recommended will depend in each case on the reason for the creation of excess demand. A war, or a business investment boom, or a consumer buying spree call for very different policies. These policies will include different combinations and doses of the same ingredients mentioned above. There is general agreement on the ingredients but room for controversy about the combinations to be used in each situation.

(b) *Cost inflation.*—In contrast to the case of demand inflation there is disagreement as to whether or not there exists such a phenomenon as cost inflation and if it exists how it can be avoided or counteracted.

The orthodox view is that if cost inflation exists it does not require any other countermeasures than the old-fashioned demand inflation. As pointed out in response to question 1, cost inflation requires an injection of money in order to become effective. Representatives of the orthodox view, therefore, conclude that to avoid cost inflation the creation of the credit needed to finance transactions at the higher cost level should be prevented. There is some logic to this argument. If in the light of cost and price rises credit expansion is denied by the monetary authorities, then business activity will contract and if the policy is pursued drastically enough prices will eventually come down. We got a relatively mild dose of that medicine in 1957. It contributed to the recession but not enough to bring prices down. A restrictive

credit policy which is an appropriate policy in case of demand inflation can effectively counteract a cost inflation only if it is drastic enough to cause a severe recession. However, the use of that policy in such a situation is not compatible with a policy designed to promote "maximum employment and production." We must, therefore, seek other more suitable policy devices to restrain cost inflation.

The various economic reports of the President and many other policy statements have employed persuasion; they have appealed to business and labor to refrain from wage and price increases which would force the price level up. Persuasion can be effective if it is backed up by a strong public opinion. It has not been, however, effective or not effective enough in the present instance. Many proposals have been made for Government measures which would help to restrain excessive price and wage increases. None of these proposals, however, has found serious legislative consideration.

I do not pretend to know the answer to this problem. In spite of all the research done on prices, wages, and productivity in relation to the general price level and the level of employment, production, and economic growth, more facts and a better understanding of these facts are needed as guide for policy decisions. Nevertheless, better facts will often be forthcoming only when some operational use requires that they be developed. Therefore, it would appear desirable that on an experimental basis procedures should be evaluated and initiated for implementing the price stabilization objective of the Employment Act. The following two interrelated proposals may deserve consideration:

1. There should be an annual conference in which representatives of business and labor, with the aid of research economists, discuss general lines of such price and wage policy which would give support to high and rising employment and production without causing inflation or deflation. Statements which could be formulated regarding a desirable general price and wage policy would be used as guidance for price and wage determination in individual industries. Regardless of whether or not agreement on price and wage policies can be reached between business and labor, the results of such a discussion should be informative for public opinion and actually may lead at least to a clearer understanding of the areas of disagreement. A better informed public opinion in itself will exert a restraining influence on price and wage policy. Actually both business and labor, for a variety of reasons cannot disregard for long the judgment of public opinion.

2. Consideration should be given to the creation of a special Government commission on prices and wage policy. The following specific proposal is meant only as an illustration of the kind of procedure which might be considered.

The commission would be authorized to undertake an examination of a select number of industries in which producers would be obliged to inform the commission of contemplated price increases and new collective bargaining agreements a short period before they become effective. The designation of those major industries would be made by the President in consultation with the Council of Economic Advisers and other Government officials. The commission in studying the proposed changes in prices or wage rates (and related benefits) would report the results of its factual investigation to the President. The

Council of Economic Advisers would then review these reports for the President who would be authorized to suspend the effective date of the change in prices and wages for a specified period of time (e. g., 60 days) if such changes were deemed to be contrary to the public interest. During this time the previous prices and wages would continue. After the end of the period the producers have the right to proceed with the price or wage change if no modification has been worked out in the meantime. A procedure similar to this is already in operation as regards the activities of the NLRB in the matter of labor-management disputes. Adoption of this relatively mild procedure might have a wholesome effect because it will put the parties on notice that the Government is seriously concerned with the task of price stabilization. This might greatly increase the chances of a success in a voluntary effort.

B. Policies to avoid deflation

The policies designed to avoid deflation are to a large extent simply the reverse of the policies designed to combat inflation, particularly demand inflation. In discussing present policies in response to a later question I will deal with policies to avoid demand deflation. Here I will add only a brief comment on cost deflation.

Why should a cost deflation be avoided? According to classical economic thinking nothing can be wrong if costs and then also prices drop. Classical economics regards a drop in costs and prices merely as a remedial process. If unemployment is prevalent, wage rates and prices drop and real purchasing power will rise; demand, production, and employment will increase as a result. In reality it is more likely that a general curtailment of wage rates will result in a drop of incomes in excess of the rise in real purchasing power which would follow from the drop in prices. This would lead to a further curtailment of employment. A general drop in prices to the extent that it would follow from a curtailment of wage rates may even have a depressing effect because it would discourage inventory holding. Therefore, a general cost and price deflation would not be desirable.

A reduction in prices of specific products may be beneficial and result in increasing sales of these commodities. This, however, differs from a cost and price decline spreading through the economy as a whole.

A SPECIAL NOTE ON A LEGISLATIVE PROPOSAL

As this question specifically calls for suggestions about legislative proposals, I would like to add a comment on the proposed amendment to the Employment Act which would specifically identify price stabilization as an objective of equal importance as "maximum employment and production". In my opinion no such amendment is needed. The Employment Act specifically calls for "maximum purchasing power" which implies price stabilization and has been interpreted this way from 1947 to 1958. This interpretation is reflected in the President's Economic Report and in statements by the Joint Economic Committee during the whole period. Price stabilization considerations have at times received even more attention in these reports than employment and production problems.

The amendment would not only be unnecessary; it would, moreover, be undesirable. It would suggest a change in the legislative mandate,

and might be interpreted as saying that, from now on, the high-employment objective should be pursued only to the extent that it is compatible with the objectives of price stabilization. People who believe that prices can be stabilized only if there is some substantial permanent unemployment may claim that the amendment sanctions their view. While this is probably not the intent of those who propose the amendment, it would be open to this kind of interpretation.

What is needed, in my view, is not a new declaration of the objective of price stabilization, but a legislative backing of an effort by business and labor to effectuate price stabilization. A proposal toward that end has been made above.

3. MONETARY-CONTROL POLICIES OF THE FEDERAL RESERVE SYSTEM, 1942 TO 1957

Monetary policies in peacetime have the objective—

(a) of supplying the economy with the money needed for sustained economic growth;

(b) of helping to channel credit in such a manner that various private and public sectors of the economy grow in balanced proportion, and that speculative excesses are prevented, as far as possible;

(c) of contributing to a price policy which supports economic growth and maintains the purchasing power of the dollar;

(d) of cooperating with the Treasury in the management of the public debt.

In emergency periods, the objective of aiding in financing Government operations (e. g., for war) may become so dominant that monetary policies must be used to restrict growth in other public and private sectors of the economy. Demand for other than war purposes was restricted by direct controls and prices were kept within limits by price controls. This was the situation from 1942 to 1946, when the problem of financing the war had higher priority than preventing current or future price inflation.

In the early postwar period, backlog demand of business, consumers, State and local government, and foreigners was so large that no particular stimulus for economic growth was needed. The main objectives of monetary policy in that situation were limiting the pressures for inflation arising from excessive demand and cooperating in the Government's debt management. With regard to the latter objective, the wartime policy of financing the Government's debt at low interest rates was the main policy objective until the so-called Federal Reserve-Treasury accord of March 1951.

With the end of World War II, the problem facing monetary policymakers was: Is it preferable to give first priority to higher interest rates as an anti-inflationary restrictive credit policy or to a policy of holding down the interest rate on Government securities in order to prevent a sharp rise in interest charges on the public debt? The decision to maintain Government long-term interest rates at a low level was based, in large measure, on the ground that a restrictive monetary policy could have made only a relatively small contribution to price stabilization, but would have cost a great deal in terms of much higher interest charges on the Government's war debt. This policy of pegging the price of long-term Government securities was

continued from 1946 to the beginning of 1951. While the policy did prevent a substantial rise in budget expenditures for interest charges, it also had the effect of paralyzing monetary policy as an anti-inflation device.

Other considerations, probably, contributed to the continuation of that policy as well. The experiences of the great depression had somewhat diminished the belief in the importance of credit policy as an effective economic stabilization policy device. Also, some economists believed that the early postwar inflation was only a short-run phenomenon and that low interest rates would be needed in the long run as a stimulus to development. Therefore, it was regarded unwise to permit a steep rise in long-term interest rates if there soon would be a need to lower them again. Finally, Government security holdings constituted such a large segment of the asset holdings of most financial institutions that a steep rise in interest rates and, hence, a steep drop in Government security prices would have had serious implications for the financial soundness of these institutions.

In retrospect, some of these arguments still appear justified; others were exaggerated.

For reasons which were not foreseeable at the end of World War II, the period of dominant inflationary pressure lasted longer than was anticipated. As a result, it was unwise to cripple monetary policy by the rigid pegging policy. It probably remains true, however, that in these first postwar years a truly restrictive credit policy would have forced up interest rates and budget charges on the national debt so much that the cost for a limited gain in price stability would have been very high. This evaluation takes into account that at war's end the banks were so liquid (holdings of short-term securities) that none of the conventional credit policies really could have prevented a considerable postwar inflation.

The Council of Economic Advisers in 1951 suggested, in an answer to a questionnaire from the Joint Committee on the Economic Report, that, in lieu of a pegged market, a "stable" market which permits some fluctuations would have been preferable. (See Joint Committee on the Economic Report: Monetary Policy and the Management of the Public Debt, pt. 2, p. 882 ff.) It would certainly have been undesirable to continue the rigid policy indefinitely. Basically, I believe that the policy adopted under the March 1951 accord of Treasury and Federal Reserve was an improvement compared with the previous policy of rigid "pegging."

There were times during the period from 1951 to 1957 when the low-interest-rate principle of the previous period was substituted by a bias in favor of high interest rates. A restrictive credit policy probably contributed to the recession of 1953, when a sharp curtailment in defense expenditures should have called for simultaneous policies stimulating expansion in other Government and nongovernment outlays. Such a policy of credit ease was adopted only after the recession had actually developed. The switch, however, may have been too drastic as an inflationary boom followed in 1955 and 1956. The monetary authorities applied the credit brakes again, but probably did not take them off promptly enough when indications appeared early in 1957 that economic expansion was falling short of the growth potential and that a downturn in business investments was in the

making. Credit restrictions were actually relaxed early in 1958, when the recession was well underway and business in general no longer responded well to ample credit at easier terms. (This should not suggest that the credit policy of 1958 was without effect—it probably had an effect on such areas as housing and local-government undertakings.)

4. FACTORS CONTRIBUTING TO THE DECLINE IN THE VALUE OF THE DOLLAR (CONSUMER PRICE INDEX FROM AUGUST 1956 TO SEPTEMBER 1957)

This was a period during which production capacity was gradually rising and no indications of an excess demand existed. Therefore, this period cannot be characterized as a period of demand inflation.

I would mention the following factors which may have contributed to the price rise:

1. There was some demand inflation in the years 1955-56, due to the high and rising rate of business investment (general price indexes did not fully reflect this inflation because of the simultaneous decline in farm prices). Demand inflation, as was pointed out in response to question 1, affects the cost structure in some instances quickly, in other instances with considerable delay (e. g., in the wages of some industries, in the rates of regulated public utilities). These rising costs, which originated in the inflation of 1955 and 1956, exerted an influence on prices in 1957 even though the conditions of demand inflation had actually disappeared. One might say that the aftereffects of the demand inflation of one period contributed to a cost inflation in the following period.

2. The wage-rate increases in 1957 exceeded productivity gains. In part, they were designed to compensate for price rises of the past; in part, they led to price rises in 1958 or were taken by business as an occasion to increase prices.

This, I would explain the price rise of 1957, in part, as a delayed aftermath of the preceding demand inflation; in part, as a cost inflation resulting from the rise in administered prices and increase in wage rates in excess of productivity gains.

6a. RELATIVE IMPORTANCE OF—

1. PRICE STABILITY
2. STABILITY OF PRODUCTION, DEMAND, AND EMPLOYMENT
3. ECONOMIC GROWTH IN PRODUCTION, DEMAND, AND EMPLOYMENT

1. Economic growth is, in my opinion, the most comprehensive economic objective. In an economy with a rising labor force and rising output per man-hour, the basic choice is between an increase in production and an increase in leisure. Under present national and international conditions, it seems to me that increased leisure has lower priority than increased production. This does not exclude some shortening in the workweek, particularly through longer paid vacations, opportunities for advanced training, and similar arrangements.

2. Stability of production, demand, and employment is desirable to the extent that growth should not be accomplished by fits and starts but, as far as possible, by sustained expansion. Nevertheless, in an

economy of substantial growth, certain sectors will at times grow faster than other sectors. Also, some sectors of the economy may actually be contracting while others are expanding. Such fluctuations have to be accepted. Widespread and prolonged contractions (recessions or depressions) or excessively rapid expansion (inflation) are undesirable. Thus, for example, when business investments slow down or decline, public investments should be accelerated or consumption promoted, if economic growth is to be maintained.

3. Price stability is desirable because a general downward movement in prices usually has a depressing effect and hinders economic growth. A general increase in prices leads to a change in the distribution of income—to the detriment of receivers of relatively fixed incomes (e. g., pension receivers). Also, a substantial general increase in prices, if continued over a period of time, leads to speculative movements and malallocation of resources. Therefore, price stability may be regarded as a corollary objective of economic growth, if understood as balanced economic growth, which means growth in proper proportion to the various elements of growth.

6b. TRENDS SINCE WORLD WAR II IN RELATION TO THESE THREE OBJECTIVES

At the end of World War II, most economists expected a period of postwar inflation (substantial backlog demand financed by ample funds before civilian production could get back in full swing) followed, possibly, by the threat of another depression. This appraisal of the economic outlook—which assumed an expected lasting demobilization of the Armed Forces—formed the background for the consideration of the full-employment bill of 1945. Broadly speaking, this concern with inflation and depression still dominated economic thinking until the outbreak of the Korean war.

During the period 1947 to 1952, the executive branch of the Government, under the leadership of the Council of Economic Advisers, while primarily concerned with anti-inflation programs, nevertheless, prepared plans for antirecession programs, should their use become necessary.

Beginning with the year 1951, it seems to me, the emphasis of economic policy shifted from economic fluctuations to economic growth. There was a growing realization that the United States probably would need to support large national security projects for a long time. During the preceding years many nondefense programs (e. g. school and hospital construction, development of natural resources) were held down on the ground that we could catch up with those programs as soon as the period of the postwar inflation was over. With the advent of hostilities in Korea it became clear that these nondefense programs could not possibly be postponed until some other demand pressures had subsided. The need to proceed on the most urgent nondefense programs had become pressing even while national security programs were still high and possibly rising. As a result, greater emphasis came to be placed on the increase in total production, and there was less concern with the threat of depression.

Some economists have gone so far as to express their belief that all emphasis should be on economic growth, that we need no longer be concerned with serious instability in production and employment, and

that some continued rise of prices had to be accepted as an unavoidable consequence of economic growth.

The economic policy of the administration in 1957 and 1958 has given at least equal consideration to the concern for current and future increases in prices as to the concern for current recession and unemployment. Monetary policy has been eased only reluctantly and piecemeal; expenditure programs even for such high priority objectives as national defense and education have been increased only within narrow limits, and tax reduction has been postponed.

It is difficult to judge whether the antirecession program up to now has been limited primarily because the economic advisers expect an early upturn in business conditions or because they fear that any larger size program, while halting and reversing the recession, may bring us back into inflation. It can only be guessed that a combination of these two factors explains the limited character of the current antirecession program. So long as prices are rising, Government decisionmakers may feel that no broad policy of credit or fiscal expansion is called for; if prices move sidewise, a policy of waiting and caution might be adopted. Thus, the fear of inflation may have led to a reluctance to pursue a policy designed first to prevent, and then to stop, the recession, and to promote the resumption of economic growth.

If the threat of rising prices is fought exclusively with a restrictive credit and fiscal policy, then we cannot be certain that we can achieve the objective of sustained economic growth. The specific proposal for price and wage policies submitted in response to question 2 is intended to bring together and to reconcile at the same time the objectives of economic growth and price stability. It is my conviction that one of the most important tasks of economic policy is to devise methods by which the objectives mentioned in this question can be reconciled.

7. THE EFFECT ON THE ECONOMY OF CURRENT FEDERAL, STATE, AND LOCAL GOVERNMENT SPENDING

In 1957, total expenditures of Governments in the United States amounted to \$114.1 billion, or about 26 percent of all production of goods and services (GNP). Of this, \$86.6 billion, or 20 percent of GNP, was spent directly by the Governments for goods and services; \$27.5 billion, or 6 percent of GNP, were transfer, interest, and subsidy payments to individuals and business, and reflected in their spending for goods and services. The size of Government has been rising both in absolute and relative terms as the following table shows.

Government expenditures, fiscal years 1939-57

[Billions of dollars except where rated as percent]

	1939	1950	1953	1957
Expenditures of—				
Federal Government.....	7.8	38.6	74.7	75.4
For goods and services.....	5.1	22.1	59.5	50.5
For transfers, etc.....	2.7	16.5	15.2	24.9
State and local government.....	9.6	22.6	27.1	38.7
For goods and services.....	8.2	19.9	24.9	35.0
For transfers, etc.....	1.4	2.7	2.2	2.7
Government total for goods and services:				
In billions of dollars.....	13.3	42.0	84.4	86.6
In percent of gross national product.....	15	15	23	26
Government total for transfers, etc.:				
In billions of dollars.....	4.2	19.2	17.5	27.5
In percent of gross national product.....	5	7	5	6
Gross national product.....	91.1	285.1	363.2	434.4

NOTE.—Details may not add to totals due to rounding.

Source: Economic Report of the President, January 1958. Survey of Current Business, July 1957. Survey of Current Business, 1954 National Income Supplement.

This very large and rising amount of Government spending is of great significance for the current economic development. This is one of the several factors which makes a downward spiraling depression of the 1930-33 variety very unlikely.

The large military demand, on the other hand, absorbs about 10 percent of the gross national product which otherwise could be devoted to productive purposes. Not only is manpower in the most productive age groups being taken out of the productive process, but especially a large number of scientists and engineers are allocating their energies to the defense effort.

The effect of this absorption should, however, not be exaggerated. Total production in the United States is so enormous and has increased so much over the years that the rise in Government expenditures (e. g. compared with 1939) has taken place at the same time as consumer expenditures and business investments have increased. A significant restriction in expenditure programs, however, has taken place with respect to nondefense Government expenditures for such purposes as schools, hospitals, resource development, urban redevelopment, and so forth. These programs, too, have risen in dollar terms, but not in proportion to total production and certainly not in relation to the needs of a rising population.

It might well be that the coming phase of development will see both an absolute and a percentage rise of these nondefense programs. If, however, a very substantial increase in national security expenditures should become necessary, some of the improvements in these nondefense programs may have to be postponed in spite of their great need and urgency.

8. THE EFFECT ON THE ECONOMY OF CURRENT FEDERAL, STATE, AND LOCAL TAXATION

The aggregate tax burden in the United States—Federal, State, and local—is heavy, amounting to approximately 25 percent of national income in 1957 in contrast with 11 percent in 1929 and 17

percent in 1939. Taxes affect the economy in two basically different ways. First, taxes affect the flow of funds. If used for financing the purchase of goods and services for public purposes, taxes transfer funds from the private to the public sector of the economy. Thus, an increase in taxes, as a general rule, reduces the share of private consumption or investment in the economy as a whole. (Whether the share of consumption or investment is reduced depends on the kind and incidence of the specific taxes.) If, however, the Government spends tax funds for making transfer payments (e. g. benefits to veterans), no reduction in aggregate private spending takes place but rather a shift in spending power from taxpayers to benefit receivers. These examples are concerned with the effects of taxes on the flow of funds and on spending throughout the economy.

Second, taxes have an effect on the attitudes and the economic behavior of people. Taxes influence incentives and thus affect the decisions of individuals and corporations. To appraise the effect of taxes on incentives and economic decisions is much more difficult than to estimate the effect of taxes on the flow of funds. Looking at the last decade, there is little evidence that the tax burden has had a generally harmful effect on work incentives. In spite of a few examples of film stars who were not interested in making more than a few pictures or of some participants in prize contests who because of tax considerations were satisfied to stop playing the game short of the final payoff, there is no evidence that individual income tax rates, in general, have discouraged productive efforts. Nor is there evidence that the high corporate tax rates have significantly reduced the willingness of corporations or curtailed the availability of funds to invest in new plant and equipment particularly for the larger corporation. Rather, part of the corporate taxes have more than likely entered the cost and price structure with the possible result that profits after taxes are not much lower than they would be with lower corporate taxes.

Nevertheless, individual tax rates, particularly in the upper income brackets are so heavy that tax provisions become an important influence in making decisions. Taxpayers in the higher income brackets try to arrange their investments in such a manner that part of their income is received in the form of tax-exempt income (State and local securities) or in form of income subject to lower tax rates (e. g., long-term capital gains).

Businessmen are conscious of the fact that outlays for research and development may be treated as business expenses and need not be treated as capital outlays. This fact has encouraged many firms to spend more on research and development programs than they would do without that tax incentive. Other influences of the tax system on business management have induced less constructive results, such as the incentive of profitable corporations to acquire deficit corporations. In some instances, such tax provisions have been the motivation for increasing business mergers.

The tax system as a whole has probably not impeded but more likely has added incentives for economic growth. In other respects tax-benefit considerations were decisive enough to lead to less desirable results. However, the latter, in general, have not been of overwhelming importance. (For a discussion of Federal, State, and local tax relationships, see answer to question 10b).

9. FISCAL POLICY AND MONETARY AND CREDIT POLICY

It is generally recognized that a budget surplus tends to have a deflationary effect and a budget deficit an inflationary effect. Nevertheless, three qualifications to that simple statement are needed.

1. An appraisal of the economic impact of the Government's budget should include not only the expenditures and taxes incorporated in what has been called the administrative budget but also those in the consolidated cash budget. The latter includes such items as the benefit payments and tax receipts of the social-security trust accounts and the income and expenditures transactions of other trust funds. Also, in appraising the effect of Government policy there should be considered the effects of debt guaranties, insurance, and other programs which are reflected in private credit transactions but are, in part, actually attributable to measures of public policy.

2. A budget deficit or surplus which results from a change in economic conditions (i. e., the automatic increase in taxes resulting from an increase in production and incomes, or the automatic decline in taxes resulting from a drop in production and incomes) does not have the same economic effect as a budget deficit which results from a deliberate increase in expenditures or a deliberate cut in tax rates. The former may help to mitigate an inflationary or deflationary movement; the latter, however, would be more effective in reversing such movements.

3. The inflationary or deflationary effect of a budget deficit or surplus respectively also depends on the debt management and monetary policy which are used. A budget deficit financed by the issue of savings bonds, for example, has a less inflationary effect than if financed by the issue of short-term bills placed with the banking system, particularly if the central bank provides the member banks at the same time with additional reserves so that they can buy the bills without reducing their liquidity. Conversely, a budget surplus has a limited deflationary effect if used for redemption of bonds in the hands of investors who are likely to use the funds immediately for other investments (e. g. mortgages). A budget surplus if used for the redemption of bank-held debts, exerts its strongest deflationary influence if the central bank at the same time increases reserve requirements so that the redemption does not increase the liquidity of the banks. This example demonstrates that fiscal and credit policies are most effective as devices to combat inflation or deflation if they are used in combination.

Fiscal policy and monetary and credit policy are devices of the same character insofar as both may effect the flow of funds and private spending. Nevertheless, in some situations the predominant use of the one or the other device is more effective.

In a situation of demand inflation (see answer to question 1) a restrictive credit policy may be effective in curtailing demand for investments, particularly in housing and local government outlays. As far as business is concerned, however, the effect is uneven because smaller businesses which depend more on credit are affected more severely than the larger firms which usually finance a sizable portion of their investments out of their own internal funds. In answer to question 2, it was pointed out that neither fiscal nor credit measures are effective policy devices for countering a cost inflation.

A policy of credit relaxation is particularly effective when private demand begins to slacken but before a general economic downturn has set in. However, once a recession is underway the easy money policy will have an effect only in specific cases—business investments and consumer purchases in general are heavily influenced by market expectations and employment prospects rather than by the availability or terms of financing. Therefore, in a recessionary period greater reliance should be placed on fiscal measures, specifically on an increase in expenditure programs and/or a reduction in tax rates. Nevertheless, fiscal antirecession measures can be most effective if supported by an appropriate monetary policy.

10b. ADEQUACY OR INADEQUACY OF THE UNITED STATES FISCAL SYSTEM

If we look at current trends in Federal, State, and local government taxation in contrast to trends in Federal, State, and local expenditures a serious problem becomes apparent.

The Federal Government largely relies upon the most productive kinds of taxes, particularly the individual and corporate income taxes which have a tendency to increase at least in proportion to the increase in total production and income. State and local governments finance the largest portion of their expenditures by sales, real estate, and other property taxes, which are regressive in character and respond to rising production, and incomes, in general, only with a time lag. Greater reliance by State and local governments on income taxes is limited because if significant State or local differences in tax rates occur, taxpayers may choose residences where taxes are lower.

If we assume that expenditures for national security need not be increased substantially during the next decade, we can expect that the greatest future growth in Government activities will be in those functions (particularly education, health, development of water resources, urban redevelopment) which traditionally have been State and local responsibilities. Under the existing fiscal system two alternatives would be readily available, namely either an increase in State and local taxes, or Federal grants-in-aid on a much enlarged basis. Neither of these alternatives appears very desirable. An increase in the State and local sales and property taxes with a relative decline in the importance of Federal income taxes would make the tax system as a whole more regressive. A larger use of the grants-in-aid program for specified purposes would magnify the problems of establishing and enforcing standards of performance. It would appear desirable to explore other possibilities, such as a Federal income tax with shares going to the States. Also the question of borrowing by State and local governments needs reexamination. Such borrowing is at present heavily subsidized by the Federal Government through the tax exemption of interest on State and local bonds. Much can be said in favor of Federal support for State and local borrowing, but the tax-exemption provision may be questioned as the best way of doing it. It is my impression that recent committees set up to examine the Federal, State, local fiscal system of the United States have made significant contributions to our knowledge of the basic facts, but have not come to grips with some of the immediate problems which are likely to attain dimensions in the future.

11. INFLATION, FULL EMPLOYMENT, AND UNEMPLOYMENT

As discussed in response to question 1, rising prices and unemployment can at times exist side by side. Such a price rise, however, is not likely to be of the character which we called demand inflation.

The price rise in 1957 may in part be explained as a delayed action arising from the inflationary situation of the years 1955 and 1956. A demand inflation in an earlier period sets in motion forces which may make for a cost inflation in a subsequent period.

I do not agree with those who suggest that we should accept a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals.

A small continuing price rise if accepted as a part of general economic policy may easily develop into a larger price rise. A continuing larger price rise is undesirable both on economic and social grounds. This should not lead to the conclusion, however, that in order to avoid a future price rise the Government should not pursue a vigorous policy designed to halt and reverse the recession and to promote balanced economic growth. The objectives of promoting balanced economic growth and price stability come into conflict only if rising prices, originating on the cost side of production, are combated by a restrictive credit and fiscal policy. One of the most important economic tasks before the country is to initiate private and public policies which are designed to limit price fluctuations without interfering with, but rather support, policies designed to promote economic growth.

13 AND 17. CAUSES OF THE RECESSION, AND THE ANTI-RECESSION PROGRAM

CAUSES OF THE PRESENT RECESSION

1. The present recession is primarily the result of an increase in productive capacity which exceeded the increase in active demand in recent years. During most of the last decade, but particularly in the years 1955 and 1956, very large increases in productive capacity took place. At the same time price rises limited the increase in active demand. This discrepancy laid the ground for a decline in business investments which is characteristic of the present recession.

2. In addition to this basic cause, there were a number of contributing factors, such as the curtailment in defense contracts in the second part of the calendar year 1957; the decline in exports due to dollar shortages in foreign countries; the continuation of a restrictive credit policy through most of 1957 even though excess capacity began to make itself felt earlier in that year.

3. Furthermore, there were secondary factors aggravating the recession. Once sales did not rise, business began to cut back inventories; consumers became concerned with the job outlook and became more reluctant to buy durable goods, particularly on installment. Also, the expectation of a price decline probably induced some consumers to postpone purchases. In recent months, the recession has been reflected in a decline in personal increases (not fully offset by rising transfer payments), which had a depressing effect in addition to the psychological effects.

THE PRESENT OUTLOOK (BEGINNING APRIL 1958) AND THE NEED FOR AN ENLARGED PROGRAM

Several of the factors making for the recession have in recent months been reversed, particularly the cutback in defense contracts and the restrictive credit policy. The reversal of credit policy coming at a time when the recession was well under way, has contributed to lower interest rates and has facilitated Government finance operations but has not resulted in any significant increase in business borrowing. Credit policy measures create a potential supply of credit but in themselves do not assure that business will actually use the additional credit made available. The decline in manufacturers' inventories is still continuing although at a reduced rate. In relation to the current rate of sales, inventories are not low, in spite of the reduction which has taken place. All in all, the pace of the decline in economic activities appears to have slowed down but indications of an upturn and a resumption of economic expansion are not yet assured.

Do the measures adopted by the Government or most likely to be adopted in the next few weeks promise to bring about such an upturn? These measures include a moderate increase in defense work, the step-up in the highway program, the facilitation of housing credit and, the supplements to unemployment insurance benefits. These measures may bring about an increase in Government expenditures of about \$3 billion in the fiscal year 1959 and, in addition, may increase private residential housing outlays by about \$1 to \$1.5 billion. It seems reasonable to expect that these measures will suffice to bring the downswing to a halt. There is a real question, however, as to whether or not these measures will be adequate to turn the tide and to restore a satisfactory rate of economic growth.

Federal Government tax revenues could fall \$5 billion short of the fiscal 1959 budget (of January 1958), assuming that the economy will continue through the fiscal year 1959 at the level of production of the first quarter of the year 1958. Thus a deficit of about \$8 billion could be expected for the 1959 fiscal year.

A deficit which is largely the result of shrinking revenue is only of limited effectiveness as an antirecession force. Broadly speaking, it helps to mitigate a downswing but does not assure the initiation of the upswing. The increase in defense work, in road building and residential construction, however, should make for some additional activity. We do not know to what extent this increase in Government expenditure programs is likely to stimulate private activities (i. e. consumption and business investments). Nor are we assured that this additional activity will do more than check a further decline. Thus, under the programs as they are now formulated there is a distinct possibility, if not probability, that with some ups and downs the economy may move sidewise at the present relatively low level for some time to come.

In such a situation those responsible for the government's economic policy must decide whether it is more prudent to run the risk of doing too much or the risk of doing too little. If we do too much we might have to adopt anti-inflationary measures at a future time. If we do too little we are wasting productive resources through idleness

and we are bearing a heavy cost in human frustrations, lost opportunities, and damage to our international good will and prestige.

It has been suggested that a bolder antirecession program would be fiscally irresponsible if undertaken in the face of an expected large budget deficit. A large recession deficit must indeed be expected for the next fiscal year and possibly for several years if effective antirecession measures are not adopted. At the present time, the choice is not between budget deficits and a balanced budget but between a recession deficit and an antirecession deficit. An increase in expenditures in excess of those now adopted and a reduction in taxation are likely to increase economic activities and thereby lead to increasing tax yields. These effects of an antirecession program will develop over time. With a greatly enlarged antirecession program the deficit in the next fiscal year may be somewhat larger than it would be otherwise. Over 2 or 3 years, however, the aggregate deficit and the increase in the national debt resulting from a prolonged recession is likely to be substantially larger than the deficit and the increase in the national debt resulting from an antirecession program. (If a bold program had been adopted, say, in January 1958, a deficit for the fiscal year 1959 might possibly have been avoided altogether.)

A budget deficit and raise in the national debt resulting from a recession is a liability with no assets to show on the other side of the ledger. An antirecession deficit creates very important assets—reduced frustration from unemployment, much needed schools, hospitals, and roads, consumer welfare, added capacity to produce, and a greatly enhanced international position.

ELEMENTS IN AN ENLARGED ANTIRECESSION PROGRAM

Proposals have been made for expanding a number of expenditure programs which need to be expanded anyway. Besides the field of national security, there are programs in the field of education, including school construction, school equipment, and higher salaries in order to attract a higher quality teaching staff. Larger programs are also needed in health, conservation and development of water resources, and urban redevelopment. In most of these fields arrangements must be worked out with the State and local governments. These programs can be fully justified on their own merit as well as on the ground of promoting sustained economic growth. But even with prompt legislative initiation it will take some time before these programs can make a substantial contribution.

Tax reduction as an antirecession device can take effect more quickly. The exact amount of needed tax reduction, however, should depend on the increase in expenditures which appear likely during the next few fiscal years. Tax reductions which (a) add to consumers' disposable income and (b) support price reductions will exert an immediate impact. A reduction in the personal income tax, with emphasis on taxpayers in the lower income brackets is particularly effective for increasing consumer income and encouraging consumer expenditures. From the point of view of both the immediate impact and the longer run strengthening of the tax system, consideration should be given to the proposal for splitting the present first \$2,000 income tax bracket and lowering the tax rate of the first \$1,000 taxable income. A reduction from the present 20 percent to 16 percent on the first \$1,000 tax-

able income, for example, would reduce tax revenues by about \$2.8 billion (although part of the reduction may be offset by rising tax yields as production and incomes increase). While this tax reduction would emphasize reduction in lower bracket incomes, nevertheless, 60 percent of the benefit from the rate changes would accrue to taxpayers with more than \$5,000 incomes. An increase in exemptions by \$100 would have a similar impact on the economy. However, the latter measure would take about 4 million taxpayers off the tax rolls. In the present international situation of uncertainty, much can be said in favor of leaving the tax base as broad as possible.

The elimination of some excise taxes could be recommended as a tax measure which would facilitate price reduction and thereby stimulate private consumption. Consideration should be given to a reduction in excise taxes amounting to perhaps between \$2½ and \$4½ billion. The National Planning Association has specifically recommended elimination of excises on transportation and communication, and on a variety of miscellaneous products, excluding taxes on alcohol and tobacco, a few regulatory excise taxes, and excluding those tax sources which are largely allocated to the highway trust fund. The National Planning Association's proposal to eliminate these miscellaneous excise taxes would cause a loss in revenue of about \$4.5 billion—again not counting the offset in other revenues which would follow from an increase in sales of these commodities. (A copy of the NPA statements on Cost of Unemployment and Priorities in Tax Reduction as an Anti-Recession Measure is attached.)

In summary, brief comments should be made regarding what fiscal measures can and cannot achieve. As was pointed out above, the basic cause of the recession probably lies in the fact that the increase in productive capacity has temporarily exceeded the increase in active demand. This explains primarily the downswing in business investments in plant and equipment and the depressed conditions in the tool and machine industries. Other contributing factors are the low level of activity in the automobile and certain export industries.

In general antirecession measures cannot be pinpointed so as to directly lift activities in industries particularly hit by the recession. Some speedup in placement of orders for automotive equipment by Government agencies or for school buses could be initiated as has already been done with military vehicles. But these can only be minor aspects of an antirecession program. The objective of an antirecession program for the general economy is to lift the level of activities in a widely dispersed number of industries and services and thereby make the solution of the particular problems of specific industries more feasible. No fiscal policy can (or should) immunize a specific industry from the effects of a miscalculation. Fiscal measures can stimulate private business investments by promoting a growing demand in the economy in general and thereby restore the markets which will again make investment in plant and equipment promising. Private business investments can be stimulated by such measures as corporate tax reduction only if the prospect for expanding markets make business expansion attractive. For this reason, the fiscal measures which have been recommended are suitable primarily for counteracting the secondary effects of the recession; namely, the general decline in consumer buying and business confidence. They cannot (and should not) re-

lieve business management of the job of making adjustments in their investments, production, and pricing policies.

16 ESCALATOR PROVISIONS IN WAGE AND OTHER CONTRACTS

Escalator clauses provide for an adjustment of wage rates or other payments usually in response to changes in the consumer price index. Sometimes they are related to productivity increases. Some contracts provide for an annual increase in wage rates so that labor shares in the benefit derived from technological and managerial advances. Productivity-related wage increases are meant to result in higher real wages, as distinct from increases which merely offset price increases. In the face of rising prices, however, productivity increases which do not provide for wage adjustments based on price increases would not accomplish their purpose.

Productivity increases have much to recommend them as a feature in wage contracts. They provide an element of flexibility for agreements extending over a number of years; they permit management to do a better long-range planning job; and they function as a spur to induce constant improvements. This assumes, however, that the automatic productivity increases are of a realistic magnitude and not of a magnitude which the firm can only pay by raising the prices for its product. To the extent that automatic productivity increases in wage contracts are desirable the use of the escalator clause is probably unavoidable.

There is still another argument against a wholesale condemnation of escalator clauses. Business management can protect their firms (and management incomes to a considerable extent) by their pricing policies. Private investors, particularly in the high income brackets, can obtain some measure of protection against price rises by investing in selected securities. In this situation it would be difficult to maintain that labor groups should not seek protection against price rises if they are in a position legally to do so.

And yet, with these arguments in mind, a realistic approach to the problem would also examine what the consequences of widespread escalation are for economic and fiscal policy.

Widespread escalation may weaken the resistance to price-inflation on the part of those who are protected by escalation; and at the same time it deprives price inflation of the function which it used to have in emergency periods (particularly during wars). A price rise resulting from an extraordinary increase in some demand factor (e. g., as result of a large Government war program) has the function of curtailing some types of demand and of helping to restore equilibrium between demand and supply at a somewhat higher price level. If the demand of some part of the population is protected against the effect of the price rise through automatic wage increases, a greater price rise will ensue and will hit with enlarged impact upon those receivers of relatively fixed incomes who do not enjoy any protection against the price rise.

In a situation of demand inflation, therefore, it is preferable both from an economic and a social aspect to curtail demand by tax and other financial measures where the impact at least in a broad way can be distributed in a manner compatible with social justice, rather than

to rely on the price spiral which results in the least justifiable distribution of the burden. The existence of escalator clauses is a strong argument for all unprotected groups of the population to demand the use of tax and other financial measures for curtailing demand, when necessary.

In this connection, it is an oversimplification to talk about the interest of labor in contrast to the interests of fixed income receivers. In this respect labor is not a unified group. Only some unions will succeed in obtaining escalator provisions and even where they are obtained they may not all be uniform and usually become effective only with a considerable timelag. A majority of labor is more likely hurt by price rises and have an interest in an economic and fiscal policy designed to keep price changes within narrow limits. Thus, in summary, in our economic and social system there seems to be no justification for preventing one group—namely, labor—from seeking protection against price rises. However, the spreading of escalator clauses makes general price changes as an equilibrating force less effective and therefore strengthens the reasons for pursuing a general policy of price stabilization.

UNIVERSITY OF CALIFORNIA,
DEPARTMENT OF ECONOMICS,
Berkeley, Calif.

Mrs. ELIZABETH B. SPRINGER,
*Chief Clerk, Senate Committee on Finance,
Washington, D. C.*

DEAR MADAM: Please find enclosed my response to the questions sent me on February 17.

Very truly yours,

HOWARD S. ELLIS.

RESPONSES TO THE QUESTIONS OF THE SENATE COMMITTEE ON FINANCE
(SENATOR HARRY F. BYRD, CHAIRMAN) BY HOWARD S. ELLIS, PRO-
FESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY, CALIF.

1. I would define inflation as a general rise in prices, and deflation as a general fall of prices.

2. I do not believe that the economy of the United States could completely avoid inflation and deflation except by so much direct control as to jeopardize the free-enterprise system. Economic progress in a free-enterprise system engenders waves, and we must accept some fluctuations up and down as the price of progress and freedom. But we need to accept neither chronic inflation nor chronic underemployment, nor do we need to experience disastrous periods of boom and bust as the price of progress and freedom. It is my conviction that, for the most part, excessive fluctuations and undesirable secular developments in prices and employment can be avoided by wise and vigorous use of fiscal and monetary controls.

For the effective use of fiscal and monetary controls, we need two changes in our laws and practices. The first is the ending of the virtual exemption of labor unions from antitrust laws. (See answers to questions 9, 10, 11, and 15). The second is the establishment of some sort of coordinating authority or council to secure unified policy among the Federal Reserve, Treasury, and the various Federal lending or credit-guaranteeing agencies. A mild measure, which would be enough if all goes well, would be a sort of interdepartmental advisory committee in the field of domestic finance, somewhat after the pattern of the National Advisory Council in the international finance field. I would be in favor of trying this measure before resorting to suggestions which have been made for a supreme monetary authority. We can probably make do with existing institutions with a little more attention to coordinating Federal lending and credit-guaranteeing activities with Federal Reserve policy. The Federal Reserve and Treasury seem to have established a practical *modus vivendi* since the accord of March 1951. The moral responsibility of securing effective general coordination lies, in the last analysis, with the administration. But a special coordinating committee or council would, probably, be useful.

3. Prior to the accord of March 1951, the Federal Reserve System was too much dominated by the objective of maintaining the prices of Government securities to be able to exercise effective monetary control. Of course, during the war years, monetary control was (and probably had to be) superseded by direct controls, such as price ceilings, rationing, and production priorities. The war was too little financed by taxation, and part of the postwar inflation could scarcely have been avoided in view of the large increase in demand deposits and currency already produced by wartime deficits in the budget. But in the postwar period the inflation was intensified unnecessarily by unjustified fears of higher interest rates and of a freer market for Government securities. Federal Reserve support of Government security prices unnecessarily expanded the credit base through open-market purchases and the creation of commercial-bank reserves. Prior to the accord, the Federal Reserve had taken some steps toward restoring monetary control, but they were much too mild.

Since the accord of March 1951, Federal Reserve policy has on the whole, been very ably and correctly conducted. It has been flexible and, until recently, rewarded with a fairly high degree of stability of prices, production, and employment. In retrospect, monetary policy should have been somewhat more restrictive during 1955, 1956, and the first half of 1957, but there were other factors in the inflation of those years, and Federal Reserve policy was not seriously lax.

4. The factors contributing to the rise of prices from August 1956 through September 1957 were partly monetary and partly non-monetary.

On the monetary side was the extensive expansion of loans by commercial banks. The course of these funds was the sale of securities by banks to private persons and nonfinancial firms, and, more ultimately, the high liquidity of these persons and firms which was a leftover from wartime money creation and the postwar years. Loans expanded while demand deposits scarcely increased. Thus, in one sense, the Federal Reserve could say that there had been no increase of money. But the sale of securities by the banks and the making of loans transferred deposits from the idle or relatively inactive to the quite active category, and velocity (as measured by debits to account) rose substantially from 1955 to mid-1957. Federal Reserve policy should have been still more restrictive in order to offset the increase of velocity.

On the other hand, fiscal policy—in the form of a higher budgetary surplus—should also have been stiffer during these months.

Another factor, perhaps second to none other, was the wage increases which, fairly clearly during 1955, 1956, and 1957, exceeded increases of productivity and, hence, were inflationary.

5. Although there are other aspects of debt management, the two most important are (1) the height and structure of interest rates, and (2) the division of debt into short term and long term. The higher are the coupon rates on Government securities, the more attractive they are to lenders in comparison with corporate securities, mortgages, and other forms of lending. Thus, higher interest rates are a brake on inflation by restricting private investment. Mortgage and other types of long-term borrowing, particularly speculative and consumer borrowing, are less sensitive. Higher coupon rates also have a tendency to restrict consumption, but this is a milder influence.

Short-dated securities, being highly liquid from the angle of the owner, do not inhibit spending as much as longer maturities. In the situation in which short-term rates are lower than long-term rates (and this is normal), there is a correct proportion of short-term (cheap) and long-term (expensive) debt to achieve the needed degree of restraint upon investment, consumption, and inflation. Interest is the necessary cost of limiting the potential inflationary influence of public liquidity resulting from holdings of Government securities. The public must be persuaded to continue to hold the securities.

6 (a). All three of the objectives are important for the economic policy of the United States; all three have, in my judgment, quite correctly, been so designated in the Employment Act of 1946.

If we were talking of the objectives of monetary policy, it would suffice to mention the first two objectives only. And, indeed, for monetary policy, I would make price stability the primary objective. Stability in production is chiefly obtained by monetary policy by means of its contribution to price stability. And the primary and, perhaps, exclusive contribution which monetary policy can make to economic growth is the securing of price and output stability. This combination is the best setting for avoiding speculative wastes and the wastes of idle plant and manpower. Monetary policy does not—and should not—include the direct control of the use of capital, and, therefore, if monetary policy makes a contribution to progress, it does so by affording an auspicious setting for the efficient operation of the price system and private enterprise.

6 (b). The United States economy has fared well, with respect to all these objectives, since World War II, when compared to most countries. Its least impressive record has been made with respect to price stability. Our largest amount of inflation came between 1945 and 1948, chiefly in consequence of wartime finance. But the record of 1955-57 was not good. (Please see answer 4.)

7. I have no criticism of the general character or present level of Government spending. If unemployment increases much over its present level, Government spending should be increased.

8. In view of present levels of unemployment, I would favor reductions in Federal income taxes, of rapidly increasing magnitude, if unemployment shows a tendency to increase.

9. Under fiscal policy, I would include the magnitude and specific composition of revenue and expenditures, the way deficits are financed (by borrowing or by money issue), and the way surpluses are used, and the management of the public debt. Under monetary policy, I would include all measures directed toward controlling the amount of money in the economy. It is obvious that monetary and fiscal policies overlap in my definitions and in fact.

To control inflation, Government receipts should be increased and expenditures decreased; taxes which discourage expenditure, particularly consumption expenditure, should be increased; coupon rates on Government securities should be raised; short-term debt should be funded into long-term debt; and the lending and debt-guaranteeing activities of the Federal lending agencies should be curtailed.

To control inflation through monetary channels, the Federal Reserve should raise its rate of discount, increase reserve requirements for the commercial banks, and sell securities on the open market.

Through the combined effects of fiscal and monetary policies it should be possible to control effectively the volume of demand deposits and currency in circulation. It is not possible for fiscal and monetary measures to control the velocity of circulation of money, since this is determined by private spending decisions. But if the volume of money is stabilized, this will operate powerfully toward stabilizing private spending decisions, and hence velocity and prices.

10 (a). Except for inflation induced by monopoly pricing (see question 11), the monetary system of the United States seems to me generally adequate to cope with inflation, if properly supported by appropriate fiscal measures. Nevertheless the monetary system would be strengthened by the founding of a coordinating council to assure that Treasury, Federal Reserve, and Federal lending agency policies are mutually consistent. A recent study of the National Bureau of Economic Research has found that the magnitude of Federal agency loans and loan guaranties approaches the magnitude of compensatory budget changes, and that, over the two decades since the lending agencies came into prominence in the thirties, the size of these loans and guaranties has as frequently changed in a direction opposed to Federal Reserve policy as conformably to it.¹ Thus the coordination of all Federal monetary activities is a matter of first rate importance.

Two other reforms are long overdue, though the Federal Reserve and the commercial banking system have been able to function despite these shortcomings. One major reform would be the requirement that all commercial banks, whether or not they are member banks of the Federal Reserve System, should be subject to the reserve requirements of the Federal Reserve. Another reform is an overhauling and simplification of the reserve requirements. Differential requirements as among central reserve, reserve city, and country banks are no longer significant; other improvements are probably needed. Detailed reforms can be worked out in consultation with officers of the Federal Reserve. These two reforms would tighten up the operation of the monetary system and afforded a more equitable distribution of the financial burden of maintaining reserves.

10 (b). I shall not attempt an answer to this question since I do not consider myself a qualified expert in public finance.

11 (a). In my judgment, the main explanation of the existence of this paradoxical phenomenon is monopoly wages and monopoly profits. Monetary policy and fiscal policy may somewhat restrain the inflationary force of monopoly but in the final analysis is incapable of dealing with it. In my own judgment, wage advances secured by monopoly labor organizations in excess of increases of productivity chiefly account for the inflation of the years 1955-57. But it is also true that monopoly profits are a fertile background for wage demands, since employers can yield and still retain adequate profits. Thus, industrial monopoly also contributes to inflation. The inflation problem will not ultimately be licked unless public policy can cope with monopoly restriction of entry and of output by both labor and industry.

11 (b). No only is a gradual inflationary trend neither necessary nor desirable in the attempt to achieve full employment; it is a serious

¹ J. Saulnier, Harold G. Hallcrow, and Neil H. Jacoby, *Federal Lending: Its Growth and Impact*, National Bureau of Economic Research, New York, 1957.

obstacle to achieving it. Any such policy, as soon as it was really thought to be settled policy, would result in inflation which would be much more than gradual. Rational action will discount the future inflation into the present and cause (as it has in South American Republics practicing chronic inflation) a rapid acceleration of the process. This inevitably leads to speculative excesses, misdirected production, pathological boom conditions, and the inevitable aftermath of recession and unemployment.

12. In general, if either private or public debt does not grow more rapidly than gross national product it does not seem dangerous to the stability or vitality of the economy. However, there are particular categories of private debt which can be dangerous. I refer to installment credit, the growth of which, I believe, has been excessive, and which helps to account for overexpansion in the automobile and some other consumer durable industries in 1956 and 1957. Also this excessive volume of installment debt now overhangs the consumer markets and will have to be worked down before there can be a revival of consumer demand.

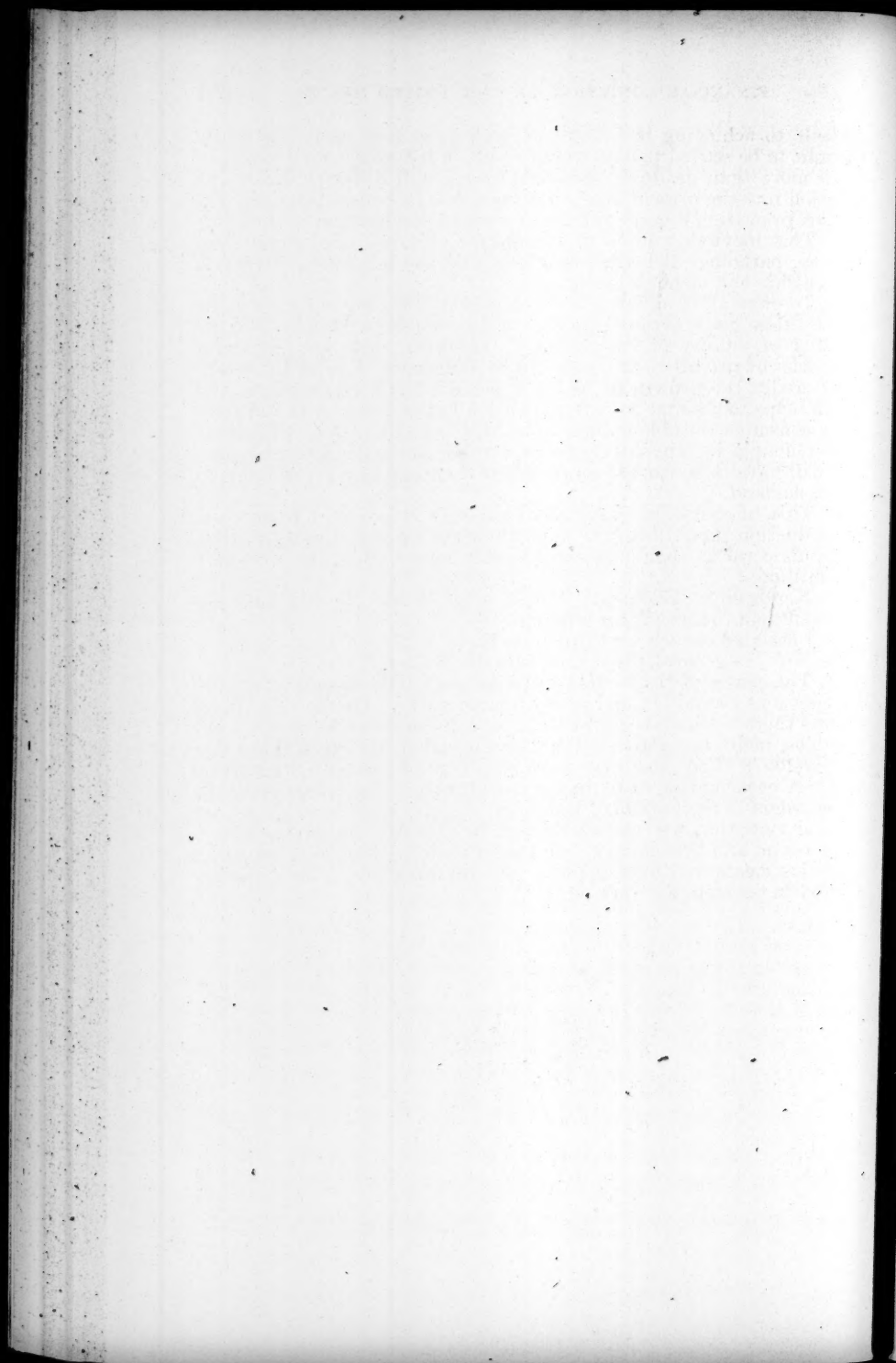
13. This, of course, is a question of anyone's judgment. In my own, tax reduction should begin if unemployment exceeds 4 or 4.5 million and public works should be considerably increased at the level of 6 or 7 million.

14. Negligibly. Budgetary deficits since World War II have not been sufficient to account for inflation.

15. Please see my answer to question 11.

16. No. In general, they exacerbate the problem.

17. The causes of the present recession are partly monetary (please see questions 10 and 11) and partly nonmonetary. On the side of real factors there has been the growth of capacity and output in consumer durables, including automobiles, at a somewhat too rapid rate prior to mid-1957. The same may have been true of residential construction. A contributing cause to the downturn was the reduction of defense orders in the middle of last year. I agree with what is a rather general view that we reached the end in 1957 of a long-term investment boom, and that it may take longer than in 1953-54 to overcome maladjustments and oversupplies. As for remedies, I have already replied in previous answers.



NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS,
New York, N. Y., March 31, 1958.

The Honorable HARRY F. BYRD,
*Chairman, Committee on Finance,
United States Senate, Washington, D. C.*

DEAR SENATOR BYRD: In reply to your letter of February 17, attached are my views on the 17 questions that you have posed. You will note the views expressed are the author's and do not represent, necessarily, those of the National Association of Mutual Savings Banks or the Association's individual members.

If I can be of further help to you, please let me know.

Sincerely yours,

GROVER W. ENSLEY,
Executive Vice President.

Attachment.

REPLIES TO QUESTIONS OF THE SENATE FINANCE COMMITTEE BY GROVER W. ENSLEY, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS, NEW YORK 17, N. Y.¹

1. Give a definition, in your own words, of deflation and inflation.

Inflation means a general increase in prices of goods and services, while deflation means a general decrease in prices. This definition is broad in scope; in practice, the terms are often confined to substantial and persistent trends, and the definition also takes no account of the antecedent forces at work. Nevertheless, the definition of inflation and deflation is a good deal easier than their measurement. Which price movements should be measured? Our economic history is replete with instances in which consumer prices moved at different rates and, indeed, in opposite directions from wholesale prices. In the postwar period, an index which attempts to measure the price movements of all goods and services produced, i. e., the gross national product, implicit price deflators, has risen every year without exception. During the same period, however, the Consumer Price Index rose nine times, fell once, and remained virtually unchanged twice. The Wholesale Price Index rose in 7 years, fell in 3 years, and remained substantially stable in 2 years. Measurement of general price movements, i. e., inflation and deflation, is also complicated by the fact that the specific articles the prices of which are included in the indexes, do not remain unchanged from year to year. Automobiles are a frequently cited illustration. While the price indexes attempt to make adjustments for changes in the product, there, nevertheless, remains considerable uncertainty about the significance of price measurements where product changes are frequent and significant.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws

¹The views expressed are the author's, and do not necessarily represent those of the National Association of Mutual Savings Banks or the association's individual members.

should be changed or new laws are required, then make specific suggestions.

In general, the control of inflation or deflation depends primarily on the proper exercise of public policies, particularly monetary and fiscal policies. Those invested with responsibility for formulating and executing public policies must be alert to changing economic conditions and adjust policies in line with such changes rather than merely on the basis of some arbitrary rules. Thus, during a period of economic expansion, fiscal, and monetary restraints should be applied with such vigor as may be needed to keep the expansion of total spending in line with the increasing availability of goods and services. This very well may require keeping taxes at rates high enough to provide substantial budget surpluses and restraints on expansion of the supply of money and credit. By the same token, in a period of recession it well may be necessary to increase the availability of credit at reduced rates of interest and to reduce tax rates and, therefore, tax revenues relative to Government spending. If the objective is to moderate fluctuations in the rates at which the economy's productive capacity is used and in the general price level, Government surpluses and deficits well may be required. They should not be eschewed on the basis of false and inappropriate analogies to private households or businesses.

On the whole, therefore, avoiding inflation or deflation depends on the alertness and responsiveness of public policies. This does not mean that such policies must be changed in response to every minor change in economic conditions. Flexibility in public policies should provide for some tolerance of minor fluctuations, up and down, in unemployment and prices.

The argument has been offered with increasing frequency in the past few years that general fiscal and monetary controls are inadequate to prevent inflation because of the control which some business and labor groups can exert over prices and wages even in the face of changing demand conditions. There is little evidence as yet to support the contention that such power, in fact, exists or is exercised effectively. If this contention can be supported, however, antitrust policy should be carefully reappraised to determine how this power can be eliminated or reduced without sacrificing basic institutions of a free, private-enterprise economy.

3. Comment generally on the monetary-control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942-50, prior to the accord, and 1951-57.)

Prior to the March 1951 "accord," Federal Reserve monetary and credit policies were based partly on fear that removal of the peg of Federal bond prices might have serious economic consequences and partly on accommodating Treasury debt management. As a result, monetary-control policies were of limited usefulness as instruments for economic and price-level stabilization. For example, during the high-employment postwar years prior to 1951, fiscal policy efforts to restrain total demand to noninflationary levels could have been expected to result in increasing liquidity pressures and a rising interest-rate structure. Efforts by the Federal Reserve to prevent any significant increase in Treasury financing costs, however, necessarily involved making additional reserves and funds available in the money market for

support of Treasury bond prices. The desired pressure on credit availability and costs to restrain total expenditures to noninflationary levels, therefore, was weakened rather than enhanced by the Federal Reserve's credit policies.

Following the "accord," the Federal Reserve System exercised considerably greater freedom to adjust its policies to meet economic stabilization requirements. Through its self-imposed strictures to conduct open-market operations solely in Treasury bills, its limited use of its power over reserve requirements, and its extensive use of rediscount-rate changes, the Federal Reserve has sought to restrict its discretionary authority over the money supply to relatively modest changes at the margin, i. e., "to lean against the wind." Some experts in monetary policy believe that the monetary authorities have, on the whole, been too cautious, too much inclined to defer action until its need has been clearly established. Others, particularly those who feel that monetary policy ought to play a relatively minor role, at best, secondary to fiscal policy, in economic stabilization believe that the Federal Reserve has been excessively restrictive in its general policy position and, on the whole, unduly concerned with the prospects of inflation.

4. Beginning in August 1956, there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The statement that the decline in the value of the dollar between August 1956 and September 1957 was caused by the continuous increase in the Consumer Price Index should be qualified along the lines suggested in response to question No. 1, above. Considerable reservations attach to measuring the value of our money in terms merely of consumer prices. While, admittedly, this is the relevant index from the consumer's viewpoint, it is not necessarily so relevant from the point of view of the producer. As noted above, divergence in the movement of various indexes is not an extraordinary phenomenon in our economy. Rising capital-goods prices or rising industrial raw-material prices well may bespeak inflation, from a number of relevant viewpoints, even if the Consumer Price Index is at the same time stable or even falling.

In very general terms, the rise in consumer prices in August 1956-September 1957 (and in subsequent months, as a matter of fact) may be attributed to the fact that, at the close of 1955, the economy was operating at, or very nearly at, full capacity. Further expansion of production to meet additional demands of business, Government, and consumers necessarily was limited by increases in productive capacity. Preventing a rise in prices of a wide range of goods and services, therefore, required limitations on the expansion of total spending.

Moreover, the rapid rate of expansion of economic activity in 1955 had inevitably resulted in bottlenecks in several important lines, in the sense that quick and substantial increases in the resources required to meet anticipated demands could come only by bidding them away from other uses. Rising costs of resources would show up in rising prices of final products, unless total demand were limited sufficiently to mitigate the incentives for bidding up resource prices and, therefore, production costs. In retrospect, therefore, it appears that a somewhat larger increase in tax revenues relative to Government expenditures

and/or somewhat greater restraint on the expansion of credit would have been advisable in 1955 and early 1956.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

I infer this question refers to management of the debt now in existence, rather than to policies determining levels of expenditures and receipts which will affect the amount of debt. In this context, debt management is concerned primarily with problems of maturity and yields of Federal obligations. From a parochial viewpoint, the objective of debt management is as far as practicable, to minimize the cost to the Treasury of maintaining any given volume of debt. If this objective were ruling, changes in the Federal debt would be guided very largely by estimates of the effective yields which would have to be paid on any specified volume of various types and maturities of debt instruments.

Whether following such a guide would necessarily be in the best interests of economic stability, however, is doubtful. Minimizing the interest charges on any given volume of Federal debt well might involve demands upon the money markets which would impair the financing prospects of private and State and local government borrowers. Such demands might be regarded as at least as important to the Nation's economic progress as those of the Federal Government. Avoiding disruptive changes in the money markets, therefore, must also be an important consideration in Federal debt management.

On a somewhat broader level, debt management must recognize that the total demand for and supply of loanable funds in the money markets reflect a wide variety of financial requirements. Different groups of lenders may seek different objectives in their investments, while the demands of various groups of borrowers also must be expected to differ. The interaction of the sum of these varying supply and demand factors determines, in effect, the structure of total public and private debt in terms of volume, interest rates, maturities, etc. The total money market, therefore, may be viewed as consisting of a number of compartments. Ideally, changes in the conditions in any one compartment quickly would affect those in other compartments. In fact, however, this interaction may be slow or sluggish, so that the consequence of any prospective change in Federal debt management for overall credit conditions may be difficult to discern in advance. Imperfect knowledge may result in debt-management actions which significantly change the relative advantages enjoyed by different groups of borrowers and lenders.

At the present time, the Treasury faces the need to refinance about \$41 billion of maturing obligations, apart from bills, before the end of fiscal 1959. In addition, continuation of present economic and budgetary trends might add some \$4 billion to \$5 billion to the Treasury's total financing requirements during the last quarter of fiscal 1958 through fiscal 1959. These demands can, to some extent, be met through the decrease in business demands for funds, which is one of the major aspects of the current recession. Thus, in the fourth quarter of 1957, business loans fell by \$0.2 billion in contrast with fourth-quarter increase of more than \$1.5 billion in 1955, 1956, and 1957. Apart from this shift in loans from private business to Govern-

ment, however, some net additional demand for credit is to be expected. So long as these demands coincide with continuation of recession conditions, expansion of bank reserves should be provided to minimize upward pressure on interest rates and diversion of credit away from non-Federal borrowers. On the other hand, should these increasing demands coincide with strong economic recovery trends, some restraint on credit expansion will be required if inflationary forces incipient in such expansionary circumstances (see No. 4, above, and No. 12, below) are to be held in check. Some rise in interest rates and decrease in availability of credit, at least relative to what might be anticipated if recessionary tendencies predominate, would be expected.

6. (a) Discuss in their relationship to one another and, according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(b) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

(a) These objectives have been considered in detail and on a continuing basis in the studies of the Joint Economic Committee and its subcommittees. (Cf. Monetary, Credit, and Fiscal Policies, Subcommittee on Monetary, Credit, and Fiscal Policies, 81st Cong., 2d sess.; Monetary Policy and Management of the Public Debt, Subcommittee on General Credit Control and Debt Management, 82d Cong., 2d sess.; Federal Tax Policy for Economic Growth and Stability, papers submitted by panelists appearing before the Subcommittee on Tax Policy, 84th Cong., 1st sess.; Federal Expenditure Policy for Economic Growth and Stability, papers submitted by panelists appearing before the Subcommittee on Fiscal Policy, 85th Cong., 1st sess.; and hearings on 1957 Economic Report of the President, 85th Cong., 1st sess.)

One of the most significant considerations emerging from these inquiries, I believe, is that no one of these objectives can be considered in isolation from the others. Public economic policy, therefore, is not called upon to rank one objective, in any absolute sense, ahead of or behind any other. The priorities to be determined, rather, refer to the extent to which gains in achieving any one objective should be put ahead of gains with respect to any other objective. Such priorities must be expected to change quite frequently in a dynamic environment. It seems clear, for example, that most policymakers were persuaded in 1956 and 1957 that increasing restraints on inflationary pressures were well worth sacrificing some of the expansion of production that, otherwise, might have been achieved. On the other hand, one can visualize circumstances in which a faster rate of growth in productive capacity might be regarded as sufficiently compelling to warrant somewhat less concern with price-level stability. At the beginning of World War II, for example, the need to expand, quickly, capacity for producing certain strategic products was generally regarded as sufficiently great to tolerate the upward price pressures which the resulting bottlenecks produced. In addition, the adverse effects on the desired

expansion of the labor force which were anticipated in any effort to offset increases in some prices by decreases in others through the use of general fiscal restraints were regarded as sufficiently serious as to warrant tolerating some (preferably modest) buildup of inflationary pressures.

No hard-and-fast rule, therefore, can be offered for determining the relative importance of various economic-policy objectives.

(b) With the benefit of hindsight, it now appears that inadequate emphasis was given to price-level stabilization in 1955 and 1956. The current recession, apparently, has weakened the inflationary impetus which developed during 1955, 1956, and the first several months of 1957, particularly if adjustment is made for the effect on food prices of normal seasonal movements and the exceptionally hard winter. Since changes in the Consumer Price Index typically lag several months behind broad changes in levels of economic activity, it well may be that consumer prices will be moving downward as the economy begins recovery. In the interests of price-level stability for the long run, public policy should seek to keep the pace of expansion of total demand within proportions consistent with avoiding further bottleneck pressures on resources, production costs, and, consequently, prices.

In this connection, it should be noted that the economic-policy objective of stability in the rate of use of our human and material productive capacity does not preclude some fluctuation in unemployment rates. Such fluctuations, of course, must be kept within bounds which are tolerable to the American people. It is clear that, if no fluctuations in employment rates were tolerated, general fiscal and monetary policies would hold little hope for stabilizing the general level of prices.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Many of the numerous questions and issues concerning the impact of present Federal spending programs on the economy were explored intensively by the Fiscal Policy Subcommittee of the Joint Economic Committee in its study in the fall of 1957 of Federal expenditure policy for economic growth and stability. The papers submitted by panelists appearing before the subcommittee, the subcommittee hearings, and the subcommittee report provide a wealth of information and analysis concerning the relationship of Federal expenditure policies to the Nation's economic development. The general policy guides offered by the subcommittee in its report warrant careful consideration. A copy of this report is appended hereto.

It is clear from this study that no simple generalization about the effects of Federal expenditures on the economy can be offered. Increases in Federal expenditures, by adding to total demand, stimulate economic activity just as any other category of spending. Similarly, Federal expenditures take up resources and, therefore, limit their availability to other sectors of the economy. One cannot say whether the net effect of these stimuli and limitations will be "good" or "bad" except in terms of one's own judgments concerning the "right" composition of the total product of the economy. No absolute standards are available, therefore, upon which to base general evaluations of total Federal spending or major components thereof. Essentially the same observations may be made with respect to State and local government outlays.

Each of us is free to assert that Government spending is too high (or too low) and to try to persuade others of the correctness of our viewpoint. The assertion may be directed primarily against waste and inefficiency (see answer to 10 (b)), although on the whole, it is extremely difficult for anyone to demonstrate the extent of such waste without a more intensive investigation of specific spending programs than most of us can undertake. But, apart from this, the assertion that Government spending is too high (or too low) merely reflects the individual's feeling that some other mix of the total product of the economy would more closely conform to his own preferences.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

For the most extended and one of the best studies of the economic effects of Federal taxation, let me commend to the committee's attention the study, Federal tax policy for economic growth and stability, undertaken in 1955 by the Subcommittee on Tax Policy of the Joint Economic Committee. The compendium of papers submitted by panelists appearing before the subcommittee in this study presents careful and well-balanced analyses of all the major features of the Federal tax system with respect to their economic effects. The subcommittee's report, Senate Report No. 1310, 84th Congress, 2d session, offers important guides for formulating tax policies consistent with steady growth of a free-enterprise economy. A copy of the report is attached herewith.

In the current situation, the subcommittee's recommendation that the level of tax revenues should be related to the level of Government expenditures by the need for full utilization of expanding productive resources is particularly topical. Following this principle would call for reduction of taxes relative to Government outlays if the basic sources of the current recession are thought to be not merely temporary and minor adjustments.

It has been very widely maintained, that present levels of tax rates are too high for the economy's long-run growth requirements if the rate of increase in Federal Government expenditures is confined to that of the post-Korean war years. For example, the Joint Economic Committee staff's projections of the Nation's economic growth to 1965 assumed reductions in Federal tax rates sufficient to reduce combined Federal, State, and local revenues 15 to 20 percent below the hypothetical yield that could be expected from present rates at income levels estimated for 1965 (Potential Economic Growth of the United States During the Next Decade, materials prepared for the Joint Committee on the Economic Report by the committee staff, 83d Cong., 2d sess.). The basic policy problem during the past 2 or 3 years according to this view has not been whether but when taxes should be reduced. During 1955, 1956, and most of 1957, the strength of inflationary pressures appeared so strong as to preclude tax reduction relative to Government outlays unless the Nation was prepared to accept much more rigorous monetary restraints than were actually imposed. The present indications of abatement of inflationary forces during the current recession suggests that this is the appropriate time for tax reductions unless significant increases in Government outlays are anticipated.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then

relate them, one to the other. Please discuss these policies stating how they may be used in restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy is concerned with management of the Government's receipts and expenditures (and consequently debt or surplus) while monetary and credit policy is concerned with the supply of money and credit, in relation to the demands therefor. Both seek to achieve certain objectives. The two sets of policies most obviously come together in connection with debt management. The extent and basic character of debt-management problems depend primarily on the receipts and expenditures results of the Government's budget, but these problems have obvious consequences for monetary policy (see No. 5, above). The immediate objectives of the two sets of policies may, of course, differ markedly, but in the present setting, their broad objectives are the same: contributing to the steady growth of the economy without price-level instability.

Fiscal policy, in addition, has long been concerned with the overall impact of Government spending, taxing, and borrowing activities on the distribution of income and wealth. Without passing judgment on the appropriateness of this concern, it is evident that fiscal policy cannot ignore whatever may be the wishes of the American people in this respect. Thus, fiscal measures which well might contribute to achieving the economic stabilization and growth objectives of public economic policies will, nevertheless, be regarded as unacceptable if they significantly conflict with the wishes of most Americans regarding the distribution of expenditure benefits and tax burdens.

One of the most provocative suggestions concerning the use and relationship of fiscal and monetary policies to achieve the Nation's economic objectives has been set forth succinctly by Prof. Paul Samuelson, in *Federal Tax Policy for Economic Growth and Stability* (papers submitted by panelists appearing before the Subcommittee on Tax Policy, Joint Economic Committee, November 1955, pp. 229-234). Professor Samuelson points out that given the expenditure by the Federal Government, the restraints on total spending necessary to prevent inflation may be provided either by monetary or tax measures. These measures may be combined in alternative ways to satisfy alternative desires with respect to the influences on levels of investment and consumption, and income and wealth distribution. As an example, the monetary authorities may provide relatively "easy" money, and as a consequence, a relatively low structure of interest rates, as a means of encouraging investment while those responsible for fiscal policies provide a relatively progressive tax structure at rates high enough to produce the budget surplus necessary to restrict total demand to noninflationary levels. Alternative combinations to meet alternative priorities among objectives similarly are feasible.

While public policymakers seldom, if ever, discuss these matters in such explicit terms, it is clear that fiscal and monetary policies in fact do reflect the type of combination Professor Samuelson discusses. Since the Revenue Act of 1954, for example, one may conclude that tax policies have sought, more than in the preceding post-war years, to encourage investment while monetary policies, until November 1957, were increasingly relied upon to check the expansion of total demand and, therefore, to restrain inflationary pressures.

Relying on hindsight, some maintain that a more restrictive tax policy and a less restrictive monetary policy might have proved more effective in moderating excessively expansionary forces in 1955 and 1956, and consequently in curbing inflationary forces. Others might well argue that since an even higher priority should have been placed on encouraging expansion of the Nation's production facilities, tax and monetary measures should have been more closely oriented to encouraging a higher overall rate of savings and somewhat lower levels of consumption. In any case, it is evident that alternative sets of priorities among objectives call for different combinations of fiscal and monetary policies.

Given the desired "mix" of objectives, the overall restrictiveness of any combination of fiscal and monetary policies should be related to aggregate supply and demand conditions and consequent pressures on stability of resource use and of the price level. For example, a prospective expansion of total demand at a faster rate than the expansion of productive capacity generally will call for increasing fiscal and monetary restraints. If relatively easy credit conditions are desired, relatively greater stringency will have to be provided by the net budget operations of the Government. On the other hand, if a smaller budget surplus (or larger deficit) is to be accepted, greater restraint will have to be exerted on the expansion of the lending power of the commercial banking system and other financial institutions.

10. (a) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exists in our monetary system.

(b) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

(a) The broadness of this question precludes a concise reply. A number of factors, including the rise of new institutions like pension funds and the rapid growth of sales finance companies, suggest the desirability of a full-dress study of our monetary system. Last year when the President proposed formation of a National Monetary Commission he further emphasized its value in seeking an answer to the question: Are savings adequate for long-run growth? A number of alternative proposals have been offered concerning the appropriate vehicle for such a study. Without discussing the relative merits of any of these proposals, I would point out that since the Constitution explicitly invests responsibility for control over the Nation's monetary system in the Congress, any inquiry should reflect this responsibility and facilitate, to the greatest possible extent, congressional action on such recommendations and findings as may be produced.

This study by the Committee on Finance already has helped to point up some of the major issues in monetary policy emerging from the post-Korean war experience. Major insights into the strength and limitations of monetary policy were provided by the Joint Economic Committee studies: Monetary, Credit, and Fiscal Policies by the Subcommittee on Monetary, Credit, and Fiscal Policies, 81st Congress, 2d session, and Monetary Policy and the Management of

the Public Debt, Subcommittee on General Credit Control and Debt Management, 82d Congress, 2d session. Further inquiry in this area should fully exploit these past contributions.

(b) In general, the reports of the Joint Economic Committee's Tax Policy Subcommittee (on Federal Tax Policy for Economic Growth and Stability) and Fiscal Policy Subcommittee (on Federal Expenditure Policy for Economic Growth and Stability), taken together, provide a valuable set of standards for evaluating Federal fiscal policies and practices. Referring to these criteria, I believe considerable improvements can be made in a number of Federal expenditure and tax programs to conform them more closely with basic principles of economy in government.

11. (a) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

(b) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

(a) For a long time past, many economists and others concerned with public economic policy assumed that economic stability, in the sense of limited fluctuations in the rate of resource use, and price-level stability were equivalent. During much of the postwar period this assumption coincided closely with observable developments. Since 1955, however, it has been apparent that some divergence between the two is quite possible.

The principal explanation of this divergence lies, I believe, in the strength of restraints within the private sector of the economy on the free movement of resources. A dynamic economy, in which mass production of industrial products is a major type of activity, will necessarily experience some unemployment, usually called "frictional," as people move from one job to another, even where overt restraints on such mobility is at a minimum. Similarly, in a dynamic environment, some idleness of production facilities is to be expected, since these, too, will be shifted among alternative uses. Such shifts cannot, of course, be made instantaneously, so that any periodic measure of labor force and capacity use is almost certain to show some unemployment. The more dynamic the economy, i. e., the more frequent and the greater the changes in technology, demands, methods of production, the larger will be unemployment of this type. Moreover, bottleneck situations are likely to arise with considerable frequency, exerting upward pressures on the prices of productive resources. If efforts are made to reduce unemployment substantially in this type of situation, these upward price pressures will be strengthened. Thus, even in a highly competitive, substantially free-market economy, some unemployment and upward pressure on prices are likely to exist side by side. If the Nation is willing to accept some fluctuation in rates of employment, a system of fiscal and monetary policies which keeps expansion of demand in line with expansion of capacity will provide substantial price-level stability in an economic setting free from overt constraints on the movement of resources.

If, however, significant monopoly elements are present in product and resource markets and if public policy does not rigorously limit the exercise of monopoly power, the problems of simultaneous stabilization of the price level and of rates of resource use are likely to

be more severe. Under these circumstances, the relative price changes required to induce a change in resource use in response to changes in demand or supply conditions are likely to be reflected in general price movements. Curbing a general price rise under these conditions will require more rigorous restraints of total demand than would be necessary in a free-market situation, with a consequently greater impact on the rate of resource use. Considering the lag in the response of prices to changes in demand conditions, therefore, one might well expect to observe rising prices and flagging rates of employment and capacity utilization at the top of a boom and in the early stages of a downturn.

(b) As indicated above (in the last paragraph of my response to question No. 2) if the situation described in the preceding paragraph in fact prevails, it seems to me that it calls not for passive acceptance of continued erosion of the value of the dollar but for vigorous public action to minimize the source of creeping inflationary pressures. If such action cannot or will not be taken, those responsible for formulating public policies will have to determine the Nation's relative priorities with respect to price-level stability as compared with stability in employment and capacity use. I submit that, since inflation cannot of itself increase the volume of real resources available under the conditions described, one must be hesitant in proposing a policy of continuing mild inflation as a solution to the problem posed. If such a policy were adopted, it is problematical that inflation could long be kept mild. The expectation of continuing erosion of the dollar's value as a deliberate policy result might well destroy present thrift patterns and increase the difficulty of providing the real savings needed to finance expansion of productive capacity.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

The growth of private debt, per se, has no necessary implications for the stability of the economy. Since, it must be remembered, debt is the basis of our money supply, the relevant consideration is the rate of its increase relative to the total real saving of the economy (assuming no change in preferences concerning the composition of liquid assets). It is possible, therefore, that debt will not increase rapidly enough, just as it is possible that it will increase too rapidly for economic stability.

Regardless of the specific form of the legal contract, a debt is created when one economic entity acquires the use of some resources or current product from another on the promise of making some sort of payment for its use. At full-employment levels of incomes it is obvious that the resources or products proposed to be acquired in this manner cannot exceed the amount of such resources or products the use of which others are willing to forego at the current payment rate. In other words, at any given rate of payment, an additional dollar of debt-financed spending must be matched by an additional dollar of real savings (again assuming no change in preferences concerning the composition of liquid assets). It is this relationship which was the basis of monetary action during the recent boom to restrict the creation of new debt through bank lending while at the same time encouraging higher levels of real savings. In the absence of such restrictions, the growth of debt financed expenditures in excess of

real current savings will produce a greater increase in total demand than can be met at existing prices with available productive capacity. The result is inflation.

On the other hand, if starting with a full-employment stable price level situation, the growth in debt-financed demand is less than current real savings, total demand will not be adequate to make full use of available human and material productive capacity. Either employment will be curtailed or prices will fall or both.

As indicated above, public-policy devices can influence both the savings and debt-creating decisions of individuals, businesses, and governmental bodies, made in free markets. In fact, it is virtually impossible to think of any public policy which would not exert some influence on these decisions. In view of the Nation's long-run growth prospects, a particularly heavy responsibility is placed on public policies to provide those influences which will match the growth of debt with a level of real savings adequate to minimize economic and price-level instability.

With the benefit of hindsight, again, it is possible that public policies did not provide sufficiently rigorous restraints to achieve this result in 1955 and in 1956. The rate of expansion of consumer debt in 1955 and of business debt in 1956, despite the restraints imposed by the Federal Reserve, incidentally, is one of the factors which have led to demands for a thorough investigation of our monetary institutions and policies.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

As my previous replies indicate, I do not believe that any specific volume of unemployment, production, or consumer demand should necessarily be regarded as calling for expansionary action by the Federal Government. Any such point designated as appropriate at any one time for any given set of conditions is more likely than not to be inappropriate at another time. Flexibility in public policies, based on alertness to major changes in economic conditions, is essential to achieving our major economic objections. These policies should not be circumscribed by any fixed rules.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

In the 12 calendar years 1946-57, cash receipts of the Federal Government exceeded cash payments in 6 years, were less than payments in 5 years and were equal in 1 year. For the full period, cash receipts exceeded cash payments by \$11.3 billion. The total cash deficit in the deficit years 1949 and 1952-55 amounted to \$10.8 billion. In current prices, total gross national product for these 12 calendar years aggregated \$3,880 billion. Deficits, therefore, represented less than 0.3 percent of income over the entire period. The deficits, per se, therefore, hardly represent a major factor in the postwar inflation.

More to the point is the question whether in view of the postwar demands upon the economy the net cash surplus for these 12 years was large enough or alternatively whether monetary policy was re-

strictive enough to provide the total real savings which were required to prevent inflation. On the whole, the answer, I believe, is "No." For the future, therefore, we would do well to be less concerned about whether there is a surplus or a deficit and more concerned about whether the amount of that surplus or deficit in relation to increases or decreases in total demand is large enough to provide reasonable stability in the price level and in resource use.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

My answers to previous questions set forth my conviction that full employment and price-level stability are compatible objectives of public policies. These objectives will not be automatically realized. Their realization will require continuing alertness and flexibility in public policies.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

If public policies are appropriately directed to economic stabilization, the present system and extent of escalator provisions in wage contracts may be regarded as relatively insignificant. If, on the other hand, public policy accepts continuing inflation, these provisions may be expected to enhance inflationary pressures.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

No simple or categorical listing of factors categorically or satisfactorily explain recessionary movements in an economy as large and as complicated as that of the United States. I shall confine my list and discussion to some factors which I believe contributed to the recession, without attempting to evaluate their relative importance. One factor is the current decline in plant and equipment outlays. According to the most recent Commerce Department-SEC survey (Friday, March 14, 1958), business reduced capital outlays from the \$37 $\frac{3}{4}$ billion seasonally adjusted annual rate in the third quarter of 1957 to a fourth quarter adjusted annual rate of \$36 $\frac{1}{4}$ billion. These outlays are expected to fall to seasonally adjusted annual rates of \$34 billion in the first quarter of 1958 and to \$32 $\frac{1}{2}$ billion in the second quarter. Since the expected total for 1958 is \$32 billion, further declines in the third and last quarters of the year are expected. If these expectations are confirmed, the fourth quarter seasonally adjusted annual rate of about \$30 billion will be 20 percent below the third quarter 1957 peak.

The reasons for this decline cannot be definitively specified. One very general explanation is that the 40-percent increase in plant and equipment expenditures in 1955-57 added more to the Nation's productive capacity than to effective demand. The result was a falling rate of plant and equipment utilization which signaled a reduction in the rate of further additions to capacity.

Another factor often cited is the cutback in placement of defense contracts during the third quarter of 1957. These cutbacks, it is averred, had adverse effects on contractors' expectations about the volume of future defense demands as well as, more immediately, on their activity in securing materials and supplies and labor force use.

Disappointing automobile sales are also identified as a contributing factor in the current decline. Whether this is properly attributable to poor consumer acceptance of style and engineering changes, to

price increases, or to a falling rate of increase in the first half of 1957 in personal disposable income is difficult to ascertain.

The income and employment effects of these developments were reflected in the very modest increase in sales in 1957 (as a whole) over 1956, and in the downturn in manufacturing sales during the latter part of the year. Reductions in new orders and inventory liquidation contributed to the downturn in total economic activity and employment since the third quarter of 1957. The decline in net foreign investment during the year also added to recessionary pressures.

Action to terminate the recession must depend on the most careful appraisal possible of the strength and likely duration of recessionary factors. On the whole, the prospective continuation of the decline in plant and equipment outlay suggests that even if further reduction in gross national product is arrested in the near future, some stimulus will be needed to provide an expansion of total demand adequate to provide job opportunities for the recently unemployed and for expected additions to the labor force.

One of the first actions to be taken is substantial easing of monetary restraints. As the Joint Economic Committee stated in its report on the January 1958 Economic Report of the President (H. Rept. No. 1409, 85th Cong., 2d sess., February 27, 1958), "monetary action should be used without hesitation and in such degree as the situation requires if, as a flexible instrument of public policy, it is to make its contribution to recovery. From the testimony presented at the hearings we find no reason why the monetary authority should under today's conditions hold back in supplying additional reserves to the monetary system. It is well recognized that such monetary action may not succeed in reversing the present economic downturn but the absence of such further action might perpetuate monetary stringency and lack of liquidity for consumers, business and Government."

If such action proves inadequate, tax reduction would be called for. The character of this reduction and its magnitude should depend on prospects concerning Federal Government expenditures. Indeed if such expenditures are expected to increase significantly tax reduction may not be warranted.

Increases (or decreases) in Federal expenditures at this time should be determined primarily on the basis of considerations other than that of economic stabilization. For example, whether defense outlays should be increased should be determined on the basis of the requirements "growing out of our own accomplishments and those of a potential aggressor"—to quote the Fiscal Policy Subcommittee of the Joint Economic Committee (op. cit., p. 4)—rather than on the basis of the effect of such increases on total levels of economic activity. Of course, the fact of an increasing amount of idle resources serves to reduce the real cost of various Federal spending programs, so that some acceleration of or increase in Federal expenditures will be in the interests of economy in Government.

In any case, it should be recognized that the larger the increase in Government outlays, the less need be the reduction in tax rates to achieve full employment. As a corollary, reductions in Federal expenditures at this time will require larger tax reductions than would otherwise be consistent with attaining high levels of employment.

HARVARD UNIVERSITY,
GRADUATE SCHOOL OF PUBLIC ADMINISTRATION,
Cambridge, Mass., April 17, 1958.

Hon. HARRY F. BYRD,
*Chairman, Committee on Finance,
United States Senate, Washington, D. C.*

DEAR SENATOR BYRD: This is the revised version of my answer to your questionnaire, which you wish to include in the compendium. I think it is now ready for printing.

May I ask whether it would be possible to get a number of prints?
Very sincerely yours,

GOTTFRIED HABERLER.

FINANCIAL CONDITIONS OF THE UNITED STATES

Reply to the letter of Senator Harry F. Byrd, chairman, Senate Finance Committee, of February 17, 1958, by Gottfried Haberler, professor of economics, Harvard University

I shall organize my remarks along the list of questions attached to the above-mentioned letter, but shall not attempt to comment on every question in the list.

Question 1. Give a definition in your own words of "deflation" and "inflation."

I define inflation as a rise in the price level, more precisely of the level of consumer prices. This is, I believe, what most people understand by inflation. Sometimes, however, a more exacting definition is proposed—namely, a mere rise in aggregate expenditure. The difference is this, that under the second definition we would have to speak of inflation when in a growing economy prices fail to decline. For example, from 1954 to 1956 consumer prices were very stable while total output (GNP) was rising. Hence total expenditure rose, and under the second definition this was a period of (mild) inflation.

I think a good case can be made for the proposition that in a rapidly growing economy the price level should be allowed to fall a little (how much I shall not attempt to determine). I shall nevertheless stick to the definition of inflation in terms of prices for the following reasons: (1) This is what most people seem to mean by inflation. (2) Although a gently falling, long-run trend in prices has certain advantages, long-run stability of prices is not incompatible with long-run growth in production and employment. (3) We shall be lucky if we prevent the long-run trend of prices from rising. There seems to be no use to set up superstandards (a gently falling price level which would be the implication of the more exacting definition of inflation) which cannot be attained in practice.

It should be observed, however, that if we want to succeed in keeping the long-run price level approximately stable, it will be necessary to have periods of falling prices, because it would be unrealistic to

assume that we can avoid periods of rising prices. (This is a theme to which I shall return again below.)

It would seem to be natural to define deflation as the opposite of inflation—that is to say, as a fall in the price level. If we do that, then by definition we can never have inflation and deflation at the same time. On the other hand, it is clear that we can have inflation and depression (or recession)¹ at the same time. That is to say, it is possible that rising unemployment and falling output are associated with rising prices. This somewhat unusual situation we are experiencing right now in the early months of 1958. (On the explanation of this phenomenon see question 11 (a) below.) We have here a choice. We can define “deflation” either synonymous with “depression” (or “recession”), or as the opposite of inflation. If we define it as synonymous with depression, it is not the opposite of inflation; we can then have inflation and deflation at the same time—as, for example, at the present time.

A third possibility is to define deflation as a fall in the quantity of money or, better, as a contraction in aggregate expenditure. (The latter definition is preferable to a definition in terms of the quantity of money because it allows for changes in the velocity of circulation of money.) Deflation in this sense is the opposite of what I called above “inflation in the second sense”—expansion of aggregate expenditure.

The three things called “deflation”—(1) drop in real output and rise of unemployment, (2) falling prices, (3) contraction in aggregate expenditure—usually go together, but not always. Hence it is necessary to distinguish the three meanings, if confusion is to be avoided.

I shall use the word “deflation” as the opposite of “inflation,” i. e., as a decline in the price level.² But if we do that it must be clearly understood that deflation in that sense is not always undesirable. As mentioned above, there are good reasons to hope that in periods of rapid growth of output per head, not only the price of individual commodities (namely, of those whose cost of production is falling because of technological progress), but also the general price level will be allowed to decline. The reasons are partly considerations of social justice, partly the prevention of a secular rise in prices. A decline in the price level allows fixed income receivers to share in the fruits of economic progress. And since it often will be impossible to prevent a rise in the price level, there should be periods of falling prices—or else we shall have a secular tendency of prices to go up, which in the long run may have serious consequences. (For more on that see question 11 (b).)

Many economists would argue that just as it is often desirable that prices in general should be allowed to fall, it is often desirable that they should be allowed to rise. In my opinion, these cases are comparatively rare except in the sense that a price rise often appears, at least in the short run, as the lesser of two evils. The most important example of that sort is the familiar one that wages are pushed up by

¹ I do not think that it is possible to make a sharp distinction between recession and depression. “Recession” is simply a mild case of “depression.”

² Everybody is, of course, free to choose the definition he prefers provided he sticks to it and is aware of its implications. Moreover, it would not be a good idea to choose a definition which runs clearly counter to general accepted usage. The trouble with the word “deflation” (to a lesser extent with the word “inflation”) is that there does not exist a firm general usage.

powerful trade unions. Then the dilemma arises for the monetary and fiscal authorities either to let the price level go up or, if they control aggregate effective demand and thus hold down prices, to permit a certain amount of unemployment to develop. Apart from this dilemma, on which I shall elaborate below (see question 11), I cannot see many cases in which a general price rise can be justified. In an earlier period (let me say before the 1940's) when depressions with sharply falling price levels used to occur, it could be argued that after such a prolonged or steep price decline prices should be allowed to rise somewhat. But today such price declines are not likely to occur. Hence there does not seem to be any justification for a compensating price rise.

In other countries such as Great Britain where international trade plays a much greater role than in the United States, a general price rise may be necessary when world market prices go up. (This is the case of "imported inflation.") In an economy like the American, which largely dominates the world economy, this cannot be regarded as a valid justification for allowing inflation to develop.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Broadly speaking, three types of policies must be relied on to avoid undesirable inflation and deflation: (1) monetary policy, (2) fiscal policy, and (3) wage and possibly price policy.

Monetary policy (including credit and banking policy) must be the first line of defense, but monetary policy cannot always do the whole job alone.

I do not believe that any major new legislation is required in the area of monetary and banking policy, except that it may perhaps become advisable, in the event that we enter a period of inflationary prosperity (which I would expect in the not too distant future), to give authority to the Federal Reserve System to regulate consumer credit, notwithstanding the fact that the Federal Reserve Board has expressed unwillingness to be vested with such authority. But this is surely not a pressing problem at the present time.

Fiscal policy (in the sense of Question 9 below) is a very powerful but rather unwieldy weapon. In periods of depression like the present or periods of fast inflation, this weapon has to be used. Its use will require ad hoc legislation. But unless Congress be willing to give the executive branch of the Government authority to vary taxes, within limits, I cannot think of any major legislative reform in that area. What is required in the area of monetary, banking and credit policy as well as in the field of fiscal policy, is good judgment, courage to apply existing weapons of policies, coordination of the farflung economic activities of the Government or, to state the same idea negatively, avoidance of contradictory policies to help special interests (for example, the shutting out of imports which necessarily raises the price of the imported commodities and so adds to the inflation pressure)—not new legislation, new agencies, and new bureaus.

Wage policy may well become a crucial factor. The long period of intermittent inflation and other factors have accustomed the labor unions to expect every year large wage increases (in the form of higher wage rates or of fringe benefits) which greatly exceed the annual

increase in labor productivity (output per man or man-hour). If aggregate demand is controlled by monetary and fiscal policies so as to prevent inflation, a rise in the wage level of more than, say, 2 percent (or $2\frac{1}{2}$ percent at the most) a year must lead to unemployment.

On the other hand, if aggregate demand is so regulated (by monetary and fiscal policies) as to maintain a high level of employment, a rise in the average wage level in excess of the normal annual increase of average labor productivity, which can hardly be more than 2 or, at the most, $2\frac{1}{2}$ percent, must lead to inflation. (For further elaborations on this point, see questions 6 and 11, below.)

Dr. Arthur Burns, the former Chairman of the Council of Economic Advisers, has made the proposal that the Employment Act of 1946 be amended so as to make stabilization of the price level a basic objective along with the maintenance of a high level of employment and growth of production.³ This seems to me an excellent suggestion. (For further discussion of various objectives of policy and their mutual compatibility, see question 6, below.)

Price policy in the sense of price control, "freezing of prices," "price stop," and the like, which have been recommended in certain quarters, seems to me entirely inappropriate, at least, in peacetime. Such policies are incompatible with the American free-enterprise system. They would lead to black or gray markets, corruption, favoritism, redtape, implying wastes, and inefficiency, which could only make things worse.

It goes without saying that this indictment does not include enforcement of the Sherman Act or an attempt to reduce certain prices by liberalizing import policies.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942-50, prior to the accord, and 1951-57.)

Prior to the accord (before 1951), the hands of the Federal Reserve System were bound. It could not help but finance inflation.

After it regained freedom of action in 1951, the monetary control policies of the Federal Reserve System have been well designed and skillfully conducted on the whole, in my opinion, although the credit relaxation after 1953 may have been pressed a little too far, as Chairman Martin himself suggested.

Major criticism has been leveled against the Federal Reserve System's policy of credit restraint in 1957. In my opinion, these criticisms have been largely unjustified. The System was caught in a dilemma. It was confronted (and is still confronted) with creeping inflation. The price level was first pulled up by brisk demand, then pushed up by rising wage costs. With the benefit of hindsight, it is now easy to see that from a narrow cyclical standpoint credit should have been relaxed earlier. But, viewed from a broader standpoint, that is to say, taking cognizance of the fact that prices had been going up intermittently ever since the outbreak of World War II and continuously since the middle of 1956, and that a long-run inflation psychology had begun to develop, the policy of restraint was necessary, in my opinion, even though it undoubtedly contributed to bringing about the present depression.

³ See his remarkable book, *Prosperity Without Inflation*. New York, 1957, p. 71.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

There are two broad factors that are responsible for the persistent rise in prices—demand pull and cost push.

The period from 1954 to early 1957 has been one of an old-fashioned peacetime investment boom. That means that during the first part of the period demand pull has been the dominant factor. In a certain sense, demand pull is always more fundamental than cost push, i. e., wage push. Even if wages are pushed up (in excess of the general rise in overall labor productivity), prices could not rise if demand was sufficiently controlled by monetary and fiscal policies. It could therefore be said that cost push by itself without expandible demand cannot push up prices. However, if in the face of wage push demand did not expand, the immediate result would be unemployment; and since we are more or less committed to maintaining overall demand at such a level as to maintain a high level of employment, the wage push draws the demand pull in its wake.

Broadly speaking, I should say that during the earlier part of the period, let me say, until the second quarter of 1957, the demand pull has been dominant. Since then, and especially at present, the wage push has become the dominant factor causing the rise in prices. (See also Question 11(a) below.)

Question 6. (a) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States.

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

There is no doubt in my mind that growth of production and maintenance of a high level of employment (avoidance of mass unemployment) is and should be the basic objective of economic policy of the United States.

Maximum growth of overall production is, however, not compatible in the long run with hundred percent stability of employment at or near the full employment level. By that I mean that mild fluctuations in output and employment of the order of magnitude of those which we had so far in 1948-49 and again in 1953-54 during the postwar period, or maybe somewhat larger fluctuations, cannot be prevented except by drastic interventions which would threaten the efficiency of the free enterprise system and thus slow down long-run growth of production and long-run improvement of economic welfare of the people.

While it is probably neither possible nor desirable to prevent the mild ups and downs in output and employment being accompanied by similarly mild fluctuations in the price level, I am convinced that it is possible and necessary for attaining maximum long-run growth to maintain long-run stability of the price level. A slight downward trend might be even better, but I would not press this point very much. It will, however, be a very difficult task to maintain stability in the price level. The principal obstacle is the incessant and excessive wage push exerted by powerful labor unions.

Question 6. (b) With respect to these three objectives (1) price stability, (2) stability of production, demand, and employment, (3) economic growth in production, demand, and employment, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

I think we have done quite well during the postwar period with respect to objectives 2 and 3, that is to say, with respect to growth and stability of production and employment. This was true, at least until recently. (It should be kept in mind that this was written in March 1958). As far as stability and growth of production and employment are concerned, the record since the end of World War II has been better than after World War I.

But with respect to objective 1—price stability—we have not done so well. If we do not want to endanger long-run growth of production and stability of employment, we shall have to do better in the future in that respect than we have done so far since World War II. (For further elaborations see question 11 below.)

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

I confine myself to asserting that from the point of view of cushioning a depression the high level of public spending is a favorable factor, for at least three reasons: (a) Public expenditure is a stable item not subject to cyclical declines in depression. (b) The leverage of the so-called "built-in stabilizers" operating through variations in tax receipts and certain types of expenditures is greater in a large than in a small budget. (c) When it comes to counteracting a decline in private expenditure and alleviating a depression, it is easier to increase public expenditure by a certain amount when starting from a high budget level than when starting from a low level.

From the standpoint of long-run growth, however, the level is certainly much higher than one would wish. But since substantially more than half of Federal expenditures are for national security it is difficult to see what can be done about it, so long as the international tension lasts.

In view of the high and unhealthy level of public expenditures I would favor, when it comes to alleviating a depression either by increased public works or by a cut in taxes, the latter method over the former.

For other considerations on that choice see question 9 below.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them one to the other. Please discuss these policies starting how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

As I have remarked earlier (see question 2 above) monetary (including credit) policy is the more flexible weapon for purposes of stabilizing the economy. But on the downswing of the cycle, as at present, monetary policy cannot do the job alone and has to be supplemented by fiscal policy. Here the basic choice is between (a) tax cuts and (b) a rise of expenditures.

In principle, I would favor the former method—tax cuts—for two main reasons: (a) It does not add to the already overextended activ-

ities of the Government; (b) it is easier to apply and acts quickly, while most types of public works require time-consuming preparations. There are, of course, exceptions to this last consideration and I would certainly not exclude an increase in expenditures altogether, especially not in the form of speeding up expenditures which will have to be made anyway later on, and such expenditures which rise automatically in a depression, such as increased unemployment relief.

It is sometimes claimed that tax cuts have the disadvantage that they cannot be easily and promptly restored once the depression is over. This objection could be overcome by limiting the tax cut to a certain period, 1 year for example, with the proviso that the old rates will come in force again automatically unless Congress voted to maintain the lower rates.⁴ It should also be observed that many of the expenditures that have been proposed are of such a nature that they cannot be quickly discontinued or reduced in volume when no longer needed. Some will even involve permanent commitments.

Increases in expenditures, it is sometimes said, have the advantage that they can be better pinpointed on areas of labor surplus. This may be true to a limited extent, but it should be pointed out that to a certain extent this objective can be achieved without increasing the total level of expenditure by redirection of expenditures already scheduled. Moreover, most depressions, especially if they are severe enough to warrant the application of the heavy artillery of fiscal policy, are fairly widespread over the whole economy. If that is the case, pinpointing is not necessary.

During periods of inflationary prosperity monetary policy should be aided by fiscal policy. If the Government runs a deficit and adds to the public debt in depressions, it should aim at a surplus in prosperous years.

Question 11 (a). What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

The unusual phenomenon of rising unemployment and sagging production combined with rising prices, which we are experiencing at the present time (early 1958), is a very dangerous development. It means that we have the worst of two worlds.

The main reason for this disquieting innovation must be sought in the downward rigidity of, and upward pressure on, wages.

It is one of the most pernicious fallacies that a boost to wages is an effective method of increasing purchasing power and thus alleviates depression. A tax cut or increase in public expenditures strengthens purchasing power. On the other hand, a rise in wages may or may not increase purchasing power of the workers (depending on what it does to employment). But in any case, whether it does or does not raise the purchasing power of the workers concerned, it boosts cost of production, it pushes up prices (or prevents prices from falling) and so reduces the real purchasing power of all consumers, including labor itself, adds to the fires of inflation and thus makes it more difficult for the monetary authorities to relax credit restrictions.

⁴ However, a tax cut that is limited to a period of a year or less than a year may not be a sufficient inducement to increase expenditure. In other words, a temporary tax cut is more likely than a permanent one to result in larger saving rather than in increased consumption expenditure. I would therefore be inclined to recommend a permanent tax cut.

Question 11 (b). Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

In my opinion, the idea that a continuous creeping inflation of 2 or 3 percent a year is unavoidable and innocuous is a dangerous fallacy which must be rejected.

I admit that the present method of wage fixing and the attitude of the powerful trade unions, which expect every year a large wage rise exceeding the average annual increase of labor productivity, poses a serious dilemma. But the problem cannot be solved by acquiescing in a continuous rise in prices. The trouble is that when prices rise by only 2 or 3 percent per year for a few years in succession, more and more people become alarmed and take steps to protect themselves. The labor unions themselves, whose policy is largely responsible for the continuing rise in prices, will ask for larger wage increases (or insist on escalator clauses) when they see that their wage rises are swallowed up by rising prices. Hence soon the price creep will become a trot and the trot a gallop. This is simply an application of the homely truth that while you may fool all people some of the time and some (though not the same) people all the time, you cannot fool all people all the time.

It has been objected to that argument that a galloping inflation is impossible in the United States. I am inclined to accept this proposition, but I submit that it misses the point. Why is galloping inflation impossible? Because the Federal Reserve will keep money sufficiently tight to prevent inflation from galloping away. But what the advocates of creeping inflation overlook is that after a while the mere attempt to keep inflation at a creeping pace (to prevent the creep from becoming a trot or a canter) will be suffering to bring about unemployment and depression.⁵ This is after all what happened last year. The advocates of creeping inflation themselves blame the tight-money policy for the present depression. I personally would say that it was a contributing factor—but let me, for argument's sake, accept the proposition that it was the main cause. Then it is undeniable that a policy which held the inflation at a creep—it did not do more than that—brought on unemployment and depression. If money had been less tight, prices would obviously have risen even faster. Sooner or later the price rise had to be stopped or slowed down. It should be observed that if it had been stopped by fiscal measures (tax increases or lower Government expenditures) as some experts had recommended, the reaction would have been the same. In that respect monetary and fiscal policies are not different in their operation. If demand is controlled either by monetary or fiscal measures and wages continue to be pushed up, the consequence must be unemployment.

Some experts are optimistic and believe that if overall demand is controlled by monetary and fiscal policy, a little unemployment or

⁵ Another very dangerous possibility is that attempts will be made to suppress the symptoms of inflation by direct control of prices and similar measures. There are not many who recommend that line of approach at the present time. But suppose we spend our way out of the depression and strong inflationary pressure builds up again—will the monetary authorities again have the courage and the power to call a halt at the risk of once more causing unemployment? I am afraid we shall hear more and more voices calling for direct controls, the totalitarian methods of a war or siege economy. This is yet another reason why it is imperative that creeping inflation be avoided. And it can be avoided without creating mass unemployment provided wages are not allowed to rise faster than the gradual rise in labor productivity.

the mere threat of unemployment will induce labor unions to relax their pressure for higher wages.

I wish and hope that this view is right. It is true that when overall demand is controlled and employers cannot easily pass on higher wages to the consumer in the form of higher prices, their resistance to wage demands will be stiffened. But I very much doubt whether a little unemployment, let alone the mere threat of unemployment, will do the job. The next few months will probably provide the answer.

One thing is certain. If price stability is to be maintained and a high level of employment preserved, money wages cannot rise on the average faster than output per man-hour—which is hardly more than 2 percent a year.

I should like to point out one important implication of this fact. Technological progress and the rise in output per man-hour is, of course not uniform over the whole economy. Some industries, let me say, certain branches of manufacturing and perhaps agriculture display faster technological advances than some others—let me say most service industries. Hence, if the overall price level is to remain stable, the prices of the products of the more progressive industries must fall and the prices of the less progressive industries must rise. This presupposes, however, that wages in the more progressive industries cannot rise as fast as productivity in those industries. If stability of the price level and full employment are to be maintained, wages in these industries cannot be allowed to rise faster than average productivity of labor in the whole economy.⁶

Suppose that labor in the progressive industries is organized in powerful unions which force up wages in proportion to the rise in productivity in those particular industries—an assumption which does not seem unrealistic—then, it is true, prices of the products of these industries need not rise. But since the American economy is sufficiently competitive to generalize, sooner or later, such a wage rise, if not fully then at least to a large extent, over most of the economy, including the less progressive industries which cannot absorb the higher wage cost without a rise of prices at which they sell, the overall price level will go up.

It follows that the policy of wage increases in proportion to (let alone those in excess of) the rise in productivity in each particular industry is highly inflationary.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

The formulation of this question suggests that there may exist some doubt as to whether the financial condition of the United States would permit the Federal Government to move at all "in major ways" to counteract a downward movement in the economy, whatever the level of unemployment. In my opinion, no such doubt should exist. At some level of unemployment action must be taken either by cutting taxes or

⁶ Or if wages in the progressive industries are allowed to rise a little faster (in order to attract labor from elsewhere), overall price stability requires that wages in the less progressive industries be reduced.

raising expenditures and the necessary rise in the debt limit will have to be voted by Congress. To make an extreme assumption, a level of, say, 10 million unemployed would constitute a major calamity which would necessitate a major move in the above sense.

It is, on the other hand, very difficult to specify a definite level of unemployment at which major steps have to be taken. The decision must surely depend not only on the absolute level of unemployment but also on the speed of the movement, on how long a given level of unemployment has persisted, on the distribution of unemployment (whether it is highly concentrated in particular areas or widely spread over the economy), on the turnover of unemployment (that is to say, the length of time individual workers remain on the average unemployed), and also on the prospects that a change for the better or for the worse is in the offing.

In all these respects there is plenty of room for honest doubt and disagreement. If I were pressed to make a quick judgment (and therefore a tentative and superficial one subject to revision in the light of further study and better information), I would say that when unemployment reaches the 6 million mark and there are no clear signs of an early reversal of the trend, the time for a major move has arrived. There would then still remain the question on the precise nature of the move and of the dosage, that is to say, by how much taxes ought to be cut or expenditures be increased.

But let me repeat and emphasize once more that all these decisions would be much easier to make, because it would not matter so much how they are made, if ours were not a period of chronic inflation. If prices had not risen so much over the last 20 years, and if the upward pressure on wages were less intense than it is, and if therefore there was less danger that by overshooting the mark the flames of inflation will be rekindled, the authorities could with good conscience take the chance of acting too soon and too drastically. Ours being a period of chronic inflation and of intense wage push, they have to watch their steps much more carefully, which increases the danger of acting too late and too little.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

I do not think that deficit spending by the Federal Government since the end of the war has been an important inflationary factor. But it cannot be denied that the large size of the budget (even if balanced) and the fact that the Government is ready to incur a deficit in periods of depression so as to counteract the decline in output and employment is, at least from the long-run standpoint, a highly inflationary factor. This is the price we have to pay for a high level of employment. But it should be stressed again that, if it were not for the excessive wage push, it would be possible to maintain a high level of employment and a large budget without creeping inflation.

Question 15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

It follows from what has been said above (especially in answer to question 11) that full employment can be maintained without inflation (i. e., while maintaining the purchasing power of the dollar reasonably stable) only if the wage level is prevented from outrun-

ning the gradual rise in average labor productivity (output per man or man-hour).

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator clauses in wage and other contracts are detrimental to economic stability. They tend to speed up the process of inflation and if generalized would lead to an intolerable instability of the price level.

Question 17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

As I have mentioned above, the present recession or depression is often blamed on the tight-money policy pursued by the Federal Reserve System or on its continuance beyond the time when it was really necessary.

In my opinion, this accusation is based on a very shortsighted view. The American economy—in fact the world economy as a whole—went from 1954 until 1957 through an ordinary investment boom as it has done many times before. True, the vigor and magnitude of the boom has been enhanced by the fact that a backlog of demand was still left over from the war. The disappearance of this backlog also aggravates the reaction. The last prosperity period has nevertheless come closer to being a regular prewar boom than any period we have had so far since the war.

It is true also that the price rise which took place during that period (wholesale prices started to climb about the middle of 1955 and consumer prices a year later) was not at all excessive by earlier standards even when disregarding war booms and immediate postwar booms. But the great difference, compared with price rises in earlier boom periods, is that these 3 boom years with rising prices are embedded in a period of almost 20 years during which there has never been any substantial price fall; in other words, the boom period in question came during an age of chronic inflation. This makes a great deal of difference and as far as the United States is concerned it is an entirely new phenomenon.

Now this investment boom had to come to an end sooner or later, as an earlier boom has. Presumably, the Federal Reserve could have kept it going somewhat longer by relaxing its tight-money policy. But there is always the danger that the subsequent reaction would be stronger, if the boom is allowed to go on longer. However, I would not press this point too much.

More important, in my opinion, is the consideration that this boom—which, to repeat, was not out of the ordinary by historical standards—occurred during a period of chronic inflation. If that had not been the case, the Federal Reserve might have been justified in taking a chance in prolonging it a little bit. Moreover, and that is even more important in my opinion, if the boom had not occurred in a period of chronic inflation, the Federal Reserve could have afforded to act more promptly and more vigorously once it became clear that the back of the boom had been broken. This condition, of course, still exists. If the present slump were situated at a valley of the price curve instead of happening at a high plateau (which is not even horizontal but has an upward though gentle inclination) monetary and fiscal policy could be applied with better conscience and hence more vigorously to end the slump.

Probably they will be applied anyway with greater vigor in the near future. Then we shall soon be back where we were: at an inflationary prosperity. That may be better than a depression with 6 million unemployed or more. But it is not a stable situation.

The chronic inflation simply has to be stopped and it can be stopped without perpetuating or creating an intolerable amount of unemployment provided wages are prevented somehow from outrunning the gradual rise of output per man-hour.

INTERNATIONAL TELEPHONE & TELEGRAPH CORP.,
New York, N. Y., May 23, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: In accordance with your request I have completed the questionnaire with respect to the investigation of the financial condition of the United States conducted by the Senate Finance Committee. My reply has been confined to the questions submitted and it is hoped that you will find them helpful in formulating sound recommendations to the Senate.

Very sincerely yours,

EDMOND H. LEAVEY.

Enclosure.

Question 1. Give a definition in your own words of deflation and inflation.

Answer 1. Inflation (as applied to money) is the reduction of the purchasing power of money; deflation, on the other hand, is the exact opposite; namely, an increase in the purchasing power of money in terms of goods or services. Inflation occurs when the demand for goods exceeds by a considerable margin the supply of goods. Inflation has been mistakenly defined by some as rising prices and deflation as falling prices. Changes in price levels are only one result of inflation or deflation.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Answer 2. It is doubtful if there is a control which would be practical and effective in curbing inflation and at the same time fall within the democratic concept of government. Resort to nondemocratic controls cannot be justified in any period other than that of war. It would seem that the only practical way of avoiding inflation would lie in complete Government control of all production, additions to plant capacity, prices, and wages. This, of course, is unthinkable. Governmental action to restrain inflation will usually involve some form of compulsory austerity which will be difficult to justify politically when the economic situation is prosperous. People will accept control of inflation only when they can be assured that the alternative is not serious unemployment and a fall in the standard of living and that it will not result in stagnation of the economy. Those people who are out of work today may have been worrying about the high cost of living last year but undoubtedly they would be willing to accept even higher costs of living rather than be out of work. To summarize, inflation or deflation probably can be prevented but the cure is one requiring governmental control which would probably be more dangerous than the disease.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942-57. (You may wish to divide the period into two parts, 1942-50 prior to the accord, and 1951-57.)

Answer 3. 1942-50: This question assumes differing answers in point of time; to limit all excesses on both the upside and downside in general economic trends one could almost say that monetary control, in the sense that the term is used today, did not exist in 1942-50. The bond market during this period was stabilized by the Treasury in order to permit financing World War II and the Korean war as cheaply as possible. Direct controls (regulation W, etc.) were introduced to contain consumer competition for goods. This form of monetary control has its place within the proper objectives of the Federal Reserve Board. Even though desirable, it is doubtful the Nation would have been willing to finance a much larger portion of the wartime expenses by way of taxes relative to that raised by the sale of bonds which leaves an aftermath of swollen money supply and continuing debt-service charges. It would take political courage of the highest degree to ask the American public to do things the hard, even though better way.

1951-57: Hindsight would permit one to be critical of some of the actions of the Federal Reserve Board and/or the timing of these actions during this period. The increase of the discount rate in August 1957 was unfortunate. On the other hand, the pronouncement in 1953 that central bank policy would, in the future, accommodate long-term economic growth via a commensurate increase in the money supply was an unprecedented advance in sophisticated money management. The 1954 shot in the arm under the influence of the same kind of downward pressures that we see today, fostered the 1955-56 excesses which, in turn, were largely responsible for the current recession. Certainly the Federal Reserve Board has made some mistakes but its operations by and large merit public commendation and admiration that the Board has accomplished as much as it did in keeping us out of serious trouble in areas where there were no controls.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Answer 4. Except for farm products and food prices, which had been declining from 1952 through the first half of 1956, other components of the Consumer Price Index had been increasing steadily. The decline in food prices tended to hide this rise. About the middle of 1956, the trend of farm and food prices reversed and started moving upward along with virtually all other prices. The main reason for the increase in food prices since the middle of 1956 has been the Federal Government's farm price support program coupled with vagaries of nature in certain instances which reduced available supplies.

One of the most important factors contributing to the increase in consumer prices was the continuing increase of labor costs which could not be absorbed by employers and had to be reflected, at least in part, in increased consumer prices.

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Answer 5. Management of the public debt with a view to issuing and refunding Government bonds at the most opportune time of the business cycle has not been and could not be expected to be very successful. Attempts to time such flotations appear to have missed the mark. One result of this practice is that too much short-term debt is outstanding. From a practical viewpoint it would probably be better to float medium- and long-term issues at periodic intervals regardless of the stage of the business cycle.

Question 6. (a) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(b) With respect to these 3 objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

Answer 6. (a) If the country is to progress and the Nation's economy is not to stagnate there must be some economic growth which, in turn, would provide for increased employment and production. Maintenance of stability of demand by economic growth would seem to be essential. It is my opinion that, of the 3 objectives set forth, the following is clearly the order of importance.

1. Economic growth in demand, followed by stepped up employment and production.

2. Stability of demand, employment, and production (again the three components have been stated in relative order of importance).

3. Price stability (not a policy basically; rather a result).

(b) The most important trend since World War II with respect to the three objectives covered by this question has been the economic growth. This economic growth has been at a higher sustained rate than in any comparable period in recent history. Brief leveling periods occurred during the 1937-38 and 1947-48 periods and we are presently in the midst or nearing the end of another period of adjustment. One of the most important trends was the endeavor immediately after the war to meet pent-up demand for all sorts of goods and services by expanding physical facilities. Demand for goods leveled off somewhat in 1954 and then was given another boost with the relaxing of consumer credit restrictions. This was followed by further extensive expenditures for facilities which brought about the boom in capital expansion in 1955-57.

It seems that the underlying cause of the postwar inflation has been the conviction on the part of labor, businessmen, and consumers that inflation was going to be with us for a long time and that all phases of the economy had to move faster in order to avoid losing ground.

Question 7. Give your opinion on the effect on our economy of current Federal, State, and local government spending.

Answer 7. There can be little question that Federal, State, and local spending has been a major factor in contributing to inflation during

the postwar period by competing with private sources for available materials and labor. Additionally, Government spending is probably more inflationary than private because of the reduced efficiencies of Government as contrasted with private business in the expenditure of Government funds during periods when both are competing for limited supplies of goods and/or labor.

It is felt that here are many activities in governmental areas which could be reduced or eliminated particularly during periods of normal business activities. During the present period, however, Federal, State, and local spending undoubtedly will prove to be one of the stabilizing factors in the economy. The anticipated increase of \$4 billion in such spending between 1957 and 1958 should offset, to a large degree, the anticipated reduction in expenditures by business.

Question 8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Answer 8. The solution to this question can contribute more in my opinion to the economic well-being of the Nation than any other phase of legislation. Present Federal, State, and local taxes, undoubtedly, divert money into public channels that could be used more constructively in private economic activities. This is one of the chief reasons why thinking people are advocating tax reductions and reforms as the foremost method of easing the current recession.

It is my firm belief that both individual and corporate income taxes are unreasonably high. Individual income taxes are so high as to be confiscatory in nature and incentives to invest, expand, and advance exist only to the extent that one finds incentive in the satisfaction of accomplishment. A tax system providing incentives could bring about the formulation of more businesses which, in turn, would build far greater opportunities for the constructive employment of a bigger segment of our population. Such employment would curtail materially the need for continuing heavy governmental expenditures and make-shift economic devices which sometimes render relief in a temporary fashion but undoubtedly tend to further increase the Federal debt and intensify the problems of inflation. It is felt that under a tax reform that would limit personal income taxes to, say 25 percent, the taxes raised from the income generated by the additional private employment and related business activities would more than offset the decline in revenues attributable to reduced tax rates. To this improvement should be added savings brought about through the reduction of governmental activities which in many instances created jobs for the sake of jobs. The same tax problems which apply to the individual are also present in the corporate tax structure, particularly in an inflationary period, because under the tax burden today a young business has little chance of existing, let alone growing.

Our economy can be strong only if both corporate and individual incentives are such that people will build new enterprises and expand existing ones, thus broadening in a material way the Nation's prosperity. It is recognized that the type of tax reform and revision that is, in my opinion, needed for the future welfare of this country will require great political courage on the part of our legislators.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stat-

ing how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Answer 9. Fiscal policy is financial policy; it is the obtaining and expenditure of Government funds. Government fiscal policy is evidenced by the financial planning currently being attempted to offset the adverse effects of the business cycle. When private expenditures are high and Federal, State, and local expenditures are increasing, some budget surplus should be set aside for use when economic conditions are less favorable. The most successful governmental use of this theory that can be recalled was the public works fund in New York during the governorship of Thomas E. Dewey. This fund subsequently was used to finance the New York State Thruway and other projects. Fiscal policy probably does more in controlling inflation than monetary and credit policies. In practice, however, there are usually strong political pressures to expend budgetary surpluses which may have accumulated so that, when economic conditions deteriorate, the Government is faced with the necessity, as at present, of increasing Government expenditures in the face of falling Government revenues.

Monetary and credit policies relate to the supply of money and the conditions under which it is used or made available. Such policies have an effect on the degree of inflation and likewise they can be extremely dangerous in their long-range effect on the economy. The effects of such policies and controls as those exercised by the Federal Reserve Board on the reserve position of member banks tend to be temporary and do not, in the long run, prevent inflation.

The Federal Reserve Board's control over inflation is considerably less than when the Federal Reserve System was established. At that time commercial banks dominated the financial system. Through them the Federal Reserve was in a position to exercise effective control. Since that time, however, commercial banks have become relatively less important in the overall financial system which includes such activities as insurance companies, sales finance companies, savings banks, building and loan associations, etc. These large segments of the financial system are controllable only in an indirect manner by the Federal Reserve Board.

Another difficulty with control through monetary and credit policies lies in the inevitable lag between the controls imposed and the time they take effect. A pertinent illustration was the increase in the discount rate by the Federal Reserve Board in August 1957. This increase was intended as a check on inflation but, by the time its effect was felt, the economy was already showing signs of recession. Another difficulty with monetary and credit controls is that they have in many instances disproportionately restricted the activities of individuals and small businesses.

Question 10. (a) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(b) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Answer 10. (a) Everything that occurs in the economic sphere involving production, distribution, consumption and services ultimately

reflects itself in the supply of money. The supply of funds coupled with the general economic outlook is more important in resolving whether or not to borrow funds for some form of acquisition or expansion than is the cost of borrowing. One of the major causes of the current recession is the limited supply of money in the face of the inflationary trend that has been in existence since the war and seems likely to continue for many years to come. The problem with our money supply probably lies in the fact that production of goods and services has not kept pace with inflation; also, there has been an over-expansion of plant facilities coupled with excessive accumulation of inventories. Unquestionably, these excesses must be brought into balance and the period during which it takes place is certain to be a disturbing one for many segments of our economy.

It is common knowledge that savings have grown materially during the recent period of recession so that some improvement in the supply of money and in the movement of money can be stimulated by sound tax reforms and tax reductions. I believe strongly that tax reform and tax reduction would be the greatest single stimulant to a continuing healthy economic climate.

(b) The problems regarding the United States fiscal system have been built up over a period of years so that the amount of money now required to service the funded debt represents a substantial part of the annual revenue. Many of the services, agencies and functions of the Government are doing a good and necessary job. The degree to which others are essential and significantly contributing to the welfare of the Nation is open to question. The report of the Hoover Commission is one of the most constructive contributions available as a guide to increased efficiency and cost reduction in governmental functions.

Question 11. (a) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(b) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

Answer 11. (a) It appears that inflation and unemployment exist side by side because of the rise in the consumer price index despite unemployment in durable goods and certain other segments of the economy. As a result of the wage contracts between employers and unions in recent years, 60 million employed can be receiving wage increases while 5 million unemployed remain out of work. Some time elapses between the slackening of demand and resultant reductions of employment; also, unemployment insurance, separation pay, payments from union funds and savings provide funds for some time after employment begins declining. In addition, the unions have negotiated to spread the work over the largest possible number of members so that, while family income is reduced, disposable income does not fall as rapidly as the rate of employment.

(b) If economic growth is accepted as desirable, a modest inflation each year may be concomitant to such growth. The only alternative to such inflation may be what we are experiencing at present—unemployment and retrenchment in industrial activities. Some inflation appears unavoidable in economic growth. Continuing inflation is

expected in this country because of the burdensome problem of servicing the Federal debt which will probably continue to rise in the years ahead. The inflationary effect upon the economy of reducing the Federal debt is well recognized and it is doubtful that any Congress would be willing to face the political hazards which would be attendant thereto.

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Answer 12. The growth of private debt in recent years undoubtedly has been one of the chief factors contributing to the economic growth of the country since World War II. Consumers and businessmen have shown their confidence in the Nation's future by incurring debt to increase output and introduce new products and services through costly research and development programs. The resultant expenditures have been a stimulus to economic activity and have improved the general standard of living. Private debt to finance installment sales has been one of the mainstays of our economy. It is difficult to imagine how the automotive, appliance and other consumer durable goods industries could have prospered as they have and provided employment and disposable income to a huge segment of the domestic economy had the consumer not resorted to private debt. Actually, private debt has grown at a lesser rate than the economy. In fact, as stated earlier, there is considerable evidence that one of the factors contributing to the current recession has been the increase in personal savings. Consumer savings are now at an all time high for normal peacetime. In the past 6 months to a year repayments on consumer installment debt have exceeded new debt incurred and some consumer credit authorities estimate that 1958 may be the first year in a decade or more in which the volume of consumer borrowings may show a decline from the preceding year. Many businesses have released sufficient cash through the reduction of inventories to repay or substantially reduce short-term debt.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

Answer 13. As indications of economic recession appear, the Government should take steps to ease the supply of money. My earlier comments regarding revisions in the approach to income taxes should not be deferred until we find ourselves in depressed economic conditions. During the course of a recession some step-up in purchasing power would be encouraged if there was some abatement in withholding taxes coupled with tax reductions. In the present business climate tax reductions are viewed as the soundest and most rapid way of correcting a recessionary trend in the economy. Public works programs may be effective in the long run but considerable time is required before they can be put into effect and, in periods of recession, the time factor is exceedingly important. Furthermore, public works are inflationary because they increase the public debt and eventually reduce the purchasing power of money.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Answer 14. Increased Government spending is inflationary irrespective of whether the budget is balanced or unbalanced. Deficit spending merely postpones the ultimate adjustment since it has the effect of running presses to print money.

Our experience since the Korean war has demonstrated the fallacy of believing that there is any correlation between inflation and deflation and between budget surpluses and deficits. In the so-called constant-dollar period of 1951-55 there was a budget deficit every year with a total deficit for the 4 years of approximately \$21 billion. Actually there was continuing inflation throughout the period, which was hidden by the decline in farm prices because of changes in farm support programs. In the years 1956 and 1957 the country experienced the sharpest inflation of the postwar period even though budget surpluses were shown in both years.

Question 15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Answer 15. It is believed that full employment goals can be maintained while maintaining the dollar with relatively stable purchasing power only if organized labor is willing to forgo wage increases greatly in excess of improvements in productivity, and if businessmen are willing to forgo unreasonable profits. The latter presents no great problem since the highly competitive nature of our economy is a most effective protection against unreasonable profits because of its pressure on price structures. Organized labor, however, has exercised strong political and economic pressures over the years for increased wages (whether direct or in the fringe benefits areas). Some segments of organized labor and pertinent labor legislation continue to be the "old man of the sea" to American industry. The vast amount of improvement in productivity is attributable to more efficient equipment which has been purchased and installed by the industries of the Nation, and not to any market improvement in the skill or output of individual workers. The rapid growth of imports of automobiles, watches, cameras, radios, office machines, textiles, apparel, etc. is evidence that the American worker is gradually pricing himself out of employment, not only in the domestic market but also in foreign markets which had been a major factor in our economy.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Answer 16. Escalator provisions in wage and similar contracts are compatible with economic stability only if they do not greatly exceed improvements in productivity which are currently estimated at about 2 percent per annum.

Question 17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

Answer 17. In my opinion the present recession is attributable to the following major causes:

(a) The release of pent-up consumer demand following the diversion to military production during World War II and the Korean war of productive facilities which, otherwise, could have been used for the production of civilian goods.

(b) The effect of this heavy demand and the accompanying limited labor supply (due to low marriage and birth rates during the 1930's) resulted in an upward pressure on price and wages.

(c) Overexpansion of productive facilities to meet the rapidly growing demand which placed undue pressure on the capital goods and building industries.

(d) In light of the above there is a probability the Federal Government contributed directly to the inflationary boom through increased Federal expenditures. There can be little doubt that some governmental authorities contributed directly to the current recession by the sudden sharp cutbacks in defense contracts during the latter part of 1957. It is also probable that the Federal monetary authorities, in their zeal to check inflation, may have checked the boom too abruptly and thus brought on the recession sooner than may otherwise have been the case; in any event this probably aggravated the decline.

The most immediate problem appears to be the restoration of consumer confidence. Such restoration requires the clear demonstration by the Government that it is genuinely interested in restoring confidence. It can probably be done best as follows:

1. A significant modification of the tax laws and a material reduction of taxes for individuals and businesses in order to stimulate purchasing for investment, expansion and current consumption.

2. A more orderly procedure for placement of defense orders. This does not mean more orders—it does mean elimination of any marked hiatus in placement of orders such as occurred in 1957.

3. Accelerated programing of already scheduled public works (particularly the interstate highway program which is far behind schedule) and projects of the Army Corps of Engineers.

4. Credit policies which will stimulate the supply and flow of money which, in turn, should improve the demand for products and bring about significant increases in employment.

